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by Audrey Freedman et al

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THE CONFERENCE BOARD'S 1985 LABOR OUTLOOK PANEL

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The Conference Board's annual session on the labor outlook took place on November 8, 1984. Panel members discussed the current economic situation, compensation trends, human resource developments, labor relations, and political events. This process provided the predictions for 1985. The individual views quoted were submitted by the participants before the discussion.

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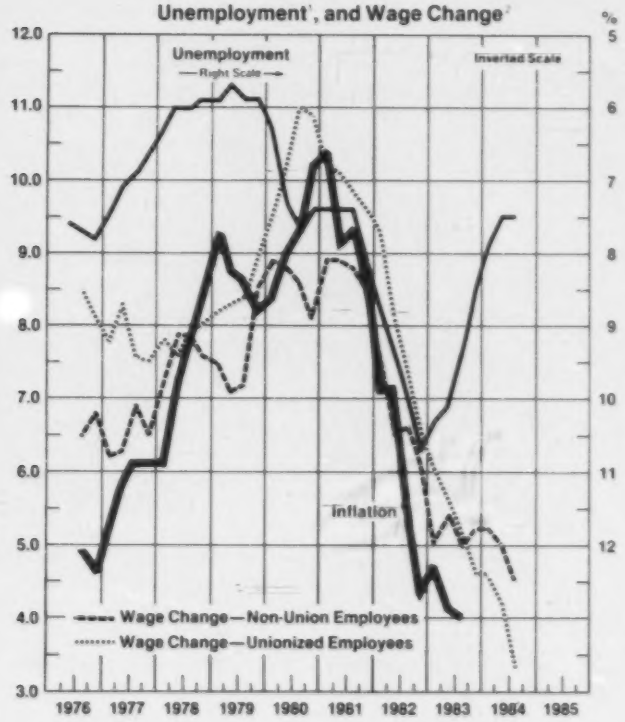
LABOR OUTLOOK 1985

The Conference Board's Labor Outlook panel foresees a year of placidity in 1985 with a small decline in unemployment, small increases in wage and price inflation, and less growth in the economy as the recovery tops out. Characteristically sensitive to portents of trouble, this year the panel found none. This does not mean that our forecasting session was ebullient; placidity would best describe the overall mood. The strength of the recovery has exceeded the panel's expectations for two years; wage inflation has moderated even though unemployment fell sharply in 1983 and 1984. Now, the panel says, a full year of plateau will ensue.

Chart 1

Unemployment[1], and Wage Change[2]



[1] Quarterly civilian unemployment rate, seasonally adjusted.
[2] Rates of Wage and Salary Change in the Employment Cost Index for Union and Non-Unionized Employees, for 12 months ending in the quarter indicated.

Labor-market recovery has been strong in 1983 and 1984, with none of the usual effect on wages, so far. (See Chart 1.) In the past year, because jobs have been available, the civilian labor force has grown by over two million—at a faster-than-normal (1.9 percent) rate. In the same period, civilians *employed* have increased by 3.6 million—a 3.5-percent rate. Yet wage inflation has not been ignited by this rapid tightening of the labor market, perhaps because the overall unemployment rate, at 7.3 percent, is still high by historical standards for a recovery.

The panel expects the unemployment rate to stay on its current level throughout 1985. (See Table 1.) In other words, no further improvement. With labor-force growth on its trend line of between one-and-a-half and two million, the panel's unemployment prediction means that it expects job creation to absorb that growth—but not to exceed it. So, in 1985, total employment will increase at about the same rate as the labor force, that is, much more slowly than it has in the two recovery years the economy has enjoyed up to now.

Two panel members suggested a slight downturn in 1985: One pinpointed the first quarter; one said "after mid-year." All joined in the discussion with some evidence of business softening in their markets. A hypothetical decline of the dollar was introduced, and rejected. The panel clearly does not foresee recession during 1985.

Inflation? Not Now

Wage increases have been sharply moderated by the recessions of the early 1980's, and they do not seem to have been affected by the recovery. In the second year of strong recovery, average hourly earnings for production and nonsupervisory workers on private payrolls have increased 2.9

Table 1: Forecasts for 1985 by The Conference Board's Labor Outlook Panel

	Median (Percent)	*Range (Percentages)*
Overall increase in average hourly earnings, January, 1985 through December, 1985	3.5	2.5 to 5.0
First-year wage and benefit increases in major union contracts	4.0	3.0 to 5.5
Increase in labor costs per unit of output in manufacturing	2.5	1.5 to 4.1
Rate of inflation (average increase in Consumer Price Index)	5.0	4.0 to 5.0
Unemployment average during 1985	7.2	6.8 to 7.7
First quarter	7.2	6.8 to 7.6
Second quarter	7.3	6.7 to 7.5
Third quarter	7.3	6.7 to 8.0
Fourth quarter	7.2	6.9 to 8.0

percent (October, 1983 to October, 1984). The panel predicts that they will rise 3.5 percent during 1985. This is clearly no portent of a wage-price spiral. Confirmation of wage moderation appears in the panel's prediction of wage and benefit increases in union contracts to be negotiated next year: 4 percent. Last year, the panel identified competitive pressures on employers as the source of continuing moderation in wage settlements and among nonunion employees. Competition developing from deregulation is continuing, if not increasing. Competition from imports is increasing because of the strength of the dollar. As a result, strong employment growth has not affected compensation.

The modest growth of compensation, more than offset by productivity increases normal to a recovery, has brought stable unit-labor costs in manufacturing, and only modestly increasing unit-labor costs in the nonfarm business sector. Preliminary data show unit-labor costs rose 0.2 percent in manufacturing and 2.0 percent in nonfarm businesses in the year ending with the third quarter of 1984. The panel predicts rising unit-labor costs of 2.5 percent for manufacturing in 1985. This, combined with their wage predictions, suggests that productivity advances of 3 and 4 percent in manufacturing overall will fall back to 1 and 2 percent in the plateau economy of 1985.

Competition, especially from abroad, and the cost pressures it produces, have postponed any inflationary surge in this now middle-aged recovery. The panel expects some increase here, to 5 percent, in 1985. (The rate of increase of the Consumer Price Index in the third quarter of 1984 for all urban consumers, seasonally adjusted, was 4.5 percent.)

The panel functions as a "scout of the future," raising questions (and consciousness) about possible turning points in the economy that affect human resources. In general, there was no turning point foreseen in 1985. The possibility of a long period of stability—much like the mid 1960's—was discussed. They see such stability for the year ahead. Scouting for other problems, the panel discussed labor supplies of technically trained employees—and found some signs of difficulty; immigration—and expected controls to be legislated; politics—and found increased lobbying might succeed in raising protection against competition, even during an Administration inclined toward a free-market ideology. These and other details of the discussion are reported below.

The 1985 Economy and Labor Market

The panel saw no signs of recession in 1985, nor of volatility, but did interpret their current business experiences to foreshadow a reduction in growth from current levels for next year. Earl Royse suggested:

> "The economy appears to be cooling from its very rapid rate of increase earlier this year. This, in itself, is helping to control price inflation; but undoubtedly the strongest single influence is our robust dollar. This foreign-exchange influence is significantly moderating price increases of goods. However, prices in the service sector, representing a full one-half of the CPI, surged at a 7.2% rate in the third quarter. We can see what would happen to the overall price level if this trend continued in the service sector and the dollar started to slip.
>
> "For the short term, however, we see continued price stability and a low rate of inflation, and level—or sinking—interest rates. That would foreshadow a further drop in the unemployment rate in the current quarter, but this might be no more than one-tenth or two-tenths of a point.

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Vice President-Human Resources
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> "In 1985, much depends on whether interest rates continue to decline as they appear to be doing—or level off, or pick up again as the year progresses. More than one analyst has forecast the latter scenario. High interest rates have already apparently begun to take their toll on several major sectors of demand in the economy. In the third quarter, new orders in general construction contracts, nondefense capital goods orders, were down. All of this should translate into a decline in the demand for labor sometime during 1985. We might thus see the unemployment rate creeping back up to about 7.5 percent. For the year, however, the average rate could be lower, depending upon the accuracy of our 1984 fourth-quarter estimate and the timing of the slowdown (perhaps only a mini-slowdown) in 1985."

Jackie Presser saw signs of a dip at the beginning of the year, followed by an extended growth period:

> "The 1985 labor market will slow at the beginning of the year following the holidays and will not immediately return to expansion. Even though current statistics show a reduction in economic expansion in the second half of 1984 and indicate continued slow growth for the first quarter of 1985, a new recession is not in the offing. The pace of job creation will accelerate as the higher rates of investment, which business surveys indicate are in the cards for 1985, result in completed new plant and equipment. However, the rate of growth will still be slower than the rapid expansion of 1984 and, consequently, will make sustained economic expansion more probable and manageable. Unemployment is likely to remain even or rise early in the year, then fall to near 7 percent by year's end.
>
> "The job-creating ability of the U.S. industrial economy has shown strength that our European allies greatly envy. Service-sector employment has grown, even during recessions. As business expands capacity, new industrial job opportunities open up and fuel further expansion of the service sector.

JACKIE PRESSER
President
International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America
Washington, D.C.

"The response the labor market makes to economic expansion will be the traditional one. As the pool of unemployed jobseekers shrinks and job opportunities expand, the market-imposed floor on the minimum wage necessary to keep employees from seeking better jobs goes up. A couple of new twists will be added to the story this time, however. First of all, in the industrial sector the impact will be largely felt in the South and West. In the service sector, with segments and companies becoming more highly capitalized and increasingly competitive on a national scale, the additional pressures of a shrinking pool of jobseekers will force many firms to focus more on long-term retention of employees. The opportunity exists for employees in the service sector to enjoy the effects of the rising wage floor to an unprecedented degree."

The group did not avoid discussing the possibility that the "plateau of 1985" was the edge of a cliff. Ted Marston raised the issue this way:

"I don't see a great deal of change in the labor market from 1984 to 1985. But there will be a continuation of the downsizing that took place in 1982 and 1983. Most of the heavy manufacturing companies still have too many people who are underutilized. The unemployment rate will not decline more in 1985. In fact, our planning is for a downturn in the economy starting in the second half."

The possibility that this is an economywide phenomenon was discussed, but rejected by the group. The farthest any would go was David Lewin's contingent description:

"An important part of the forecast of continued, if slower, economic growth in 1985 is the combination of wage and price moderation, both of which appear likely to be sustained. However, if wages were to rise rapidly in 1985 (which is unlikely), or if prices were to rise rapidly in that year (more likely to occur, especially if the money supply is expanded and interest rates fall), a turndown in the economy could occur earlier and at a faster pace in 1985 than I previously predicted."

Dan Mitchell suggested that some isolated event could cause a sudden sellout of dollars and U.S. investments by foreign owners. The dollar would depreciate, inflation would be triggered, the Federal Reserve would act to increase interest (partly to attract foreign capital back, partly to dampen inflation), and a recession would ensue. But he did not give the scenario much credence. His analysis:

"The economy currently does show signs of slowing from the rapid pace of expansion during the first half of 1984. It may even 'pause.' But recession will not begin. Big federal deficits do not necessarily cause recessions unless they trigger inflation that the Federal Reserve finds unacceptable. Deficits do reduce the rate of national saving, which means less investment and/or more borrowing from abroad."

John Richardson focused on the deficit as a cause of instability in his own prediction of growth:

"Private credit demands will begin to clash seriously with federal financing requirements in the first half of 1985, as a result of the huge structural budget deficit. At this juncture, the Federal Government's demand for the limited supply of savings will begin to 'crowd out' private-sector demand, pushing up interest rates on a long-term cyclical basis and preventing any future growth. Nothing has been done to date to correct this structural deficit and to change the current game plan."

The consensus forecast, offered after this discussion, is that employment will continue to expand at about the same rate as the labor force grows. Consequently, unemployment will be stable. All agreed that efficiency drives among employers are still on, and still cutting labor input.

Compensation

There is almost no upward pressure on wages in the economy, so whatever increases are occurring are quite spontaneous. First, *inflation* (steady, and about 4 percent) is not causing a clamor for more pay "to keep up." Second, *union power* to push for wage hikes has faded fast where employers resisted them. Finally, *labor supply* is generally abundant, so bidding up wages to acquire employees from another firm seldom occurs. There is nothing in this economy to generate compensation increases.

In 1985, the panel sees the same situation. It expects a modicum of added inflation, but no increase in union power or tightening in the labor market. So, its wage projections are just a small amount higher than at present (Table 1). Robert Neylan summed up his point of view as follows:

"Employers are budgeting between 5 and 6 percent for salary increases, and slightly less for hourly payrolls. With inflation down from the 1979-1980 levels, and unemployment still high, bargained increases are still going to be at moderate levels. There are 106 million people employed, but no one is expecting a big pay day; those who are employed are glad to be employed and simply want to stay even with whatever the level of inflation turns out to be."

David Lewin and John Richardson both emphasized that there will be considerable variation from the overall rate of increase. Lewin said:

"White-collar workers in industries in which firms are continuing to follow long-term reductions in force—industries such

as oil and insurance—will receive only modest pay increases, say 3.0 to 4.0 percent. White-collar and professional employees in the computer and office machine industries will receive larger increases, on average, say between 6.0 and 9.0 percent, but this will depend heavily on the size and market position of the firm in which they are employed. Some occupational specialities—such as computer programmers, systems analysts, petroleum engineers, geologists and managers of financial services—may well receive double-digit pay increases in 1985.

"In contrast, production workers and other blue-collar employees are likely to receive relatively modest pay increases in 1985, say from 2.0 to 5.0 percent depending upon the industry and firm in question. Wage increases that go into effect in 1985 as a result of collective-bargaining agreements negotiated previously and first-year wage increases resulting from newly bargaining (1985) labor agreements will be modest, in the 2.0 to 4.0 percent range.

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"In 1985, I also expect to see the expanded use of profit sharing, bonuses and employee stock-ownership plans for nonmanagement employees as forms of compensation. These will reflect the continued trend toward the use of productivity and ability to pay as major wage-setting criteria, a trend which began to be observed in the early 1980's. Correspondingly, less emphasis will continue to be placed on inflation and comparability in the determination of wages in the U.S. economy in 1985."

John Richardson emphasized industry variation:

"As economic growth extends, wage gains will begin to rebound. However, as economic growth has been uneven among the various sectors, so will the wage increases. Those industries still experiencing difficulties (including steel, aluminum, airlines and agricultural implements) will probably continue wage freezes and, in some instances, will extend wage cuts.

"Wage growth will be held in check to the 6 percent level because the unemployment rate will cut into employee bargaining power. In addition, as productivity growth is expected to be moderate (3 percent), this will tend to keep a lid on unit-labor costs. Finally, companies need to help keep unit-labor costs down in order to keep prices down. The increased competition stemming from deregulation in various industries, the flood of lower-price imports resulting from the strong dollar, and the emergence of very competitive nonunionized industries all point to a tightening in compensation.

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"Additionally, unit-labor costs will remain low for three primary reasons:

(1) reductions in the labor force due to layoffs;
(2) continued wage concessions in labor contracts;
(3) more efficient and effective management of labor.

"The first two factors are clearly evident in the construction, airlines, steel, rubber, auto and energy industries. These industries have been extremely hard hit by the past recession. In many cases, their only alternative to remain competitive within their markets was to reduce labor costs. This was accomplished by layoffs and seeking wage concessions from their unions. Only recently have many of these depressed industries experienced any true growth."

The wage forecasts in Table 1 all refer to nonexempt employees: production, clerical and nonsupervisory workers of all types. Information in the box on page 9 covers forecast increases for several levels of employees of private businesses, surveyed by compensation consulting firms. These are generally 2 to 3.5 percentage points higher than the increases for nonexempt workers upon whom the panel focused.

Skill Shortages and Labor Market Operation

As the labor market tightens, shortages of some kinds of workers appear. Employers, bidding such workers away from other jobs, escalate wages in those occupations. This wage bidding may be confined to a particular geographic area, or specialized industries and specialized technical occupations and backgrounds. While the panel did not identify this type of wage escalation problem in the 1985 labor market, it did devote much discussion to mismatches between the skills and qualities that employers are seeking and the available labor force. There was little resolution of the question: Is the labor market operating efficiently?

There are shortages of technically trained professionals, such as specialized engineers and computer scientists; there are also shortages of technical craft workers, such as tool and die makers. According to panelists, the college and graduate-school population contains too few scientifically oriented students. Moreover, panelists felt that high-school graduates today lack sufficient background in basic mathematics and sciences—and are difficult to train because

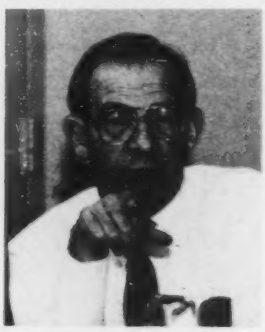
of this. Another theme was that potential employees are resistant to geographic relocation.

As for the already-experienced worker, there are several barriers to reemployment after layoff. Former wage scales, even for unskilled factory work, give the unemployed unreasonable expectations and a sense of disappointment at "having to start all over again." The incentive to relocate is not very strong at low wage rates, especially when the former worker will lose so much of the investment in home, in status, in job accommodation.

Ted Marston observed:

"It seems to me that just looking at unemployment numbers doesn't really tell you what is going on in this country.

"In our area of the country, there is a major problem of employment for young people (18 to 24) with only a high-school education. There are no jobs available to this group other than in fast food chains or in cleaning rooms in a motel. Therefore, many of our young people are leaving the Midwest and going to the Southwest.



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"Retraining is another critical issue. We are finding that many workers who are being retrained have low skills in reading, writing and math. Because of their skill level they are forced to accept jobs at a substantially lower rate than the wage they received at Cummins. There are many examples of people going from $20,000-a-year jobs to $8,000-$10,000-a-year jobs."

The discussion underlined the existence of strong employer demand—in specific locations, for very specific skills and background, mostly technical—at the same time as the unemployment rate seems "stuck" above 7 percent. The highly anecdotal discussion indicated that the U.S. labor market, flexible and responsive as it is, is not operating at full efficiency in this recovery. There seems a strong possibility that we are underinvesting in the employment adaptation of our population.

Protectionism

Protection from competition, though not part of the present Administration's philosophy, has been extended to "political" industries such as steel, autos, textiles and apparel, and sugar. Frequently, the main justification is to

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sustain employment in the competition-threatened industry. While it is difficult to assemble a constituency of "consumers for free trade," the *industrial* consumers of, say, copper, can organize to forestall protection and price increases.

The question is: What extensions of protection might develop in 1985? Dan Mitchell commented:

"Steel never gets all the protection it wants, but it always gets something when it makes a push. Just a few weeks ago, President Reagan announced in triumph that he was not going to restrict trade in steel, just get 'voluntary' arrangements with steel-exporting nations to do it for us. Since it will take some time to negotiate this deal, steel will definitely get more protection in 1985 than it has now.

"Autos will probably not be made to go cold turkey into open foreign competition. Something will remain of the 'voluntary' quotas. But a second Reagan Administration will not be worried about domestic political concerns. Thus, it seems unlikely that more protection will arrive in 1985."

Robert Neylan added;

"The Administration is targeting reductions in imports of both steel and machine tools, using its 'jawboning' authority under the 1974 Trade Act. As we limit steel imports, industries that use steel must pay a higher price. Those industries then pass the added cost on to their customers.

"Any reductions in imports, and there have been some, will be 'voluntary' lest a general tariff war break out.

"Our experience with deregulation suggests that we are going to be better off when the government finally gets out of the regulation business. In the airlines, we finally have some competition on at least some routes; and the traveling public is better off for it. Vested interests (the pilots, mechanics and the unions) are taking some lumps but the public is reaping the benefit. Railroads are finally in a position to compete, and they are extending their reach into other logical areas of activity. Rates are down and service is better; a shipper has a choice among forms of transportation.

"Banking is the one area where I would expect more deregulation activity. It is about time for the regulators to recognize that the marketplace has long ago passed them by. In 1982, the Gara-St. Germain Act authorized banks to expand into financial services, long after so-called nonfinancial institutions had created a whole new market in services.

"Without doubt, there is sentiment for reregulation. It is typically motivated by self-interest but does not, at this point,

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Vice President-Employee Relations
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contemplate restoring regulation to prior levels. Railroad consumer groups would like to water down the Staggers Act of 1980 because it is in their direct interest to do so. The insurance industry is said to be lobbying to stop banks from getting into the insurance business. The surviving truckers want to reregulate to stop new truckers from entering the business and for a form of rate control to end pricing wars. *Everyone favors the free market—except in their own backyards.* Competing is hard work—who needs it if there is an easier way?

"Steel capacity will continue to decline as the industry adapts to the changes that have taken place in the world. Companies will concentrate on specialty items where they can capitalize on their expertise or technology. The mini-mills are here to stay, since they can make a profit at reduced levels of operations. Steel companies have already branched out into financial service and oil, and more will diversify as it becomes clearer that Uncle Sam is not going to protect them.

"Railroads, trucks and barge lines will increasingly compete and the strongest—those that can offer service at competitive rates—will survive. Railroad mergers are commonplace and there will be more. Railroads are expanding into trucking and eventually, like CSX, some will recognize opportunity in the barge and airline business."

John Richardson noted that protection cannot freeze out the forces reducing costs:

"The impact of any protectionist or regulatory policy has been and always will be: (1) increased prices to the customer; (2) reduction in the competitive strength of the affected industry; (3) inflexibility to changing market factors; and (4) lack of any incentive for adaptive re-structuring to remain viable, resulting in a continuing need to remain protected or regulated.

"However, those very industries remaining protected are facing tremendous global competition from foreign imports due to the strength of the U.S. dollar. As a result, even though protected, these industries need to either freeze or reduce their wage levels and/or work force in order to remain price competitive."

Collective Bargaining and the Shrinkage of Unions

The unions' loss of wage power has been a subject of discussion by the Labor Outlook panel for three years. It is now fully acknowledged. The collective-bargaining settlement data tell a story of continuing "concessions." The following tabulation shows first-year wage adjustments in contracts covering 1,000 or more workers in the period indicated.

	1983	January-September 1984
Percent of workers affected, who received wage increases:	63	73
Wage freezes	22	21
Wage decreases	15	6
Mean wage adjustment	2.6%	2.5%
Mean wage increase	5.8%	4.2%
Mean wage decrease	-6.7%	-9.0%

In the second year of recovery, union concessions are still being negotiated. Chart 1 shows that the rate of wage increase for unionized employees in the whole economy has trailed that for unorganized employees since the second year of recovery began. Dan Mitchell said:

"I think that the wage concessions of the early 1980's were partly corrections for the widening union-nonunion wage differential in the 1970's. It is quite possible that union wage increases will continue to run below nonunion, or at least not faster."

Ted Marston surveyed recent trends and events, arriving at these conclusions:

"Negotiated wage rates will continue to be in the same range as 1984 for heavy manufacturing. Many companies will try to establish pay systems that do not go into the base pay system, that is, bonus plans and profit-sharing plans. Also, we will see more lump-sum payments or a combination of lump sum and bonus (like GM). Negotiated variable pay systems will continue to increase over the next three to five years.

"We have seen in the GM and Ford contracts that management is willing to spend its dollars on employment security and pensions. Both contracts were designed to help reduce the size of the work force. In both cases, the company was willing to pay in order to maintain its ability to move work out of the company. I believe much of this work will be moved offshore.

"It appears that the auto companies decided against any long-range plan to try to retrain and redeploy their existing work force. As a result, I doubt they will get the gains necessary in productivity and quality to stay competitive with the Japanese, or even the Europeans. This must mean they are hoping for continued protection, and that they intend to automate a great deal more than they have up to this time."

Looking at the overall decline in union wage power, John Richardson concluded:

"Unions have ceased to be the economic force controlling wage patterns and employment conditions. They are, in fact, gradually evolving into a special-interest group. The pattern bargaining of the past is no longer a viable apparatus; wage bargaining is being custom-fit to the individual needs of the company.

"Reagan's reelection will foster and encourage this trend—but the trend itself is unavoidable. There are various reasons for the unions' decline in economic strength and vitality,

A Survey of Surveys: Salary Plans

	Level of Employee	1984 Salary Increase	1985 Planned Salary Increase
American Compensation Association	Executive	6.8%	6.7%
	Exempt Salaried	6.5	6.5
	Nonexempt Salaried	6.4	6.4
The Conference Board	Exempt Salaried	6.5	6.5
Executive Compensaton Service, Inc. A Subsidiary of The Wyatt Company	Executive	6.7	6.5
A.S Hansen	Executive	6.6	6.5
	Exempt Salaried	6.4	6.4
	Nonexempt Salaried	6.2	6.2
Hewitt Associates	Executive	6.8	6.5
	Exempt Salaried	6.2	6.2
	Nonexempt Salaried	6.1	6.0
Sibson & Company	Executive	6.9	6.7
	Exempt Salaried	6.5	6.5
	Nonexempt Salaried	6.3	6.3

1984 actual salary increases and those planned for 1985 are almost the same. This is a continuation of the fall from earlier inflation-driven levels where, at their peak, increases reached double digits. Even though salary increases are at their lowest level in ten years, the continued low rate of inflation is producing a real earnings gain for employees, while allowing employers to escape from the necessity of using salary increases as catch-up cost-of-living adjustments and to put more emphasis on linking pay to individual performance.

Charles Peck
Senior Research Associate
The Conference Board

primary among them is their rapid decline in membership. Total membership in labor organizations accounts for less than 20 million workers, and estimates of 10 to 15 percent of the work force being unionized by 1990 are commonplace.

"USW has lost one-half of its membership over the last three years. The shrinkage of the smokestack and basic industries, steel, rubber, auto, textiles, has resulted in the U.S. economy moving out of labor-intensive production and into capital-intensive production. Additionally, growth in high-technology manufacturing—electronics, communication, aerospace—has resulted in a restructuring of the labor markets into highly skilled knowledge workers and reduction in the number and proportion of semi-skilled craftworkers."

But Jackie Presser saw a role for unions in service industries:

"In the post-World War II decades, service-sector employment has grown dramatically, even during recessions. As business expands capacity, new industrial job opportunities open up and fuel further expansion of the service sector. The most important challenge facing the U.S. economy is to make these new industrial and service jobs ones that can support the U.S. standard of living. This is the labor movement's greatest task for the future, and in my opinion the key to building economic strength and sustaining long-term economic expansion."

Richardson's response to this suggestion was:

"As the basic industries began to reduce their work forces and concession bargaining became the predominant pattern, there has been less and less incentive for workers to unionize. Workers no longer view unions as a means to assure income and job security. Those industries most heavily unionized were hardest hit by the recession and the last to recover. White-collar workers in the service and high-tech industries have never been prone to unionism, and they never will organize unless unions develop an appropriate strategy for recruiting them.

"Management is practicing more enlightened personnel policies. This is apparent in the number of quality-of-worklife programs being pursued, the greater attention to the development of effective communication programs, and the growth of productivity-improvement programs with pay-for-performance compensation schemes. In these circumstances, unions have very little opportunity to recruit members."

David Lewin closed the discussion with this statement:

"The AFL-CIO and major constituent unions might begin to reassess their basic political, organizing and bargaining strategies. The combined tide of public and business opinion is running strongly against organized labor and, together with the continuing decline in the proportion of workers organized, this presents a major challenge to union leaders to reassess their

Employee Commitment Requires Employment Security: Ted L. Marston

"Another approach is to ensure the people in your work force that their employment will be secure if they really work hard at increasing productivity and improving quality. Then you develop *all* of the people into a highly trained, highly effective work force. Those who lose jobs because of productivity gains will be trained to do new work that has been brought into the organization.

"One of the vital leadership tasks is to identify and procure work necessary to keep your work force challenged and growing. The redeployment and retraining of the work force is a central role for everyone. Then new work is only brought in if the job design and methods are so effective that the work can be done as cheaply in-house as by others. This forces the organization to look at new ways of doing work. It forces managers to redesign work and train people to produce more effectively than in the past.

"If you have a unionized work force, it allows you to talk about how work can be done more effectively. You work together in designing the work for flexibility. It gives ownership to everyone involved in making the change."

basic strategies. If they fail to do this, they will surely continue to experience declines in number and proportions organized, political influence, and public standing. The Reagan victory may be good for organized labor—if it brings about a major reassessment on the key fronts noted above."

Returning to union bargaining, the panel predicted first-year wage and benefit increases in major contracts (those covering 1,000 or more workers) of 4 percent. Taking benefit inflation into account (as the data in our text table do not), this projected rise is slightly greater than the 1984 experience to date. This suggests fewer concession contracts, with wage freezes or cuts, than in recent years. Mr. Presser said:

"Negotiated wage settlements for 1985 will be very similar to contracts negotiated in 1984. Wage increases for employees will go up slightly—but unions will continue to negotiate lower new-hire rates, and wage progression scales for new hires that stretch out the length of time required to reach the top of the scale. Employers will continue their attack on work rules and paid time off, concentrating on restricting the application of premium pay provisions, increasing flexibility in making job assignments to workers across job classifications, and reducing the number of personal and sick days."

The 1985 collective bargaining calendar (Table 2) includes some negotiations that used to be notable national "events" in the wage reverberations they caused, and in their sheer size and comprehensiveness across an industry. Now the structure has shattered and "industrywide" is inapplicable—nor is companywide appropriate. The Chrysler negotiations in the Fall of 1985 are separated from 1984's General Motors and Ford bargain by a year, and by different wage levels and formulas (there is no profit sharing at Chrysler). The rubber bargain next April has already become "a smashed system, with concessions going down to the plant level," as Dan Mitchell put it. In trucking, side agreements have already excepted companies and units from the "master" agreement. Earl Royse said:

"The most interesting labor development in the trucking industry is the revelation that only 29 large truckers (so far) will participate in group bargaining next Spring under the mantle of Trucking Management, Inc. This is down from 125 in the last round of negotiations, and some might say that this could hardly be called 'industry' bargaining. Apparently, many of the rest of the employers intend to go their independent ways, although some may play 'wait and see' on how bargaining progresses. This alone may provide an incentive to the Teamsters to produce a workable pact, since it can be presumed they would not like to see their national agreement under glass at the Smithsonian Institution any time soon.

"After the three-year wage freeze in 1982, it seems that the union has to produce something this time. But the average wage and benefit cost of unionized carriers is now about $18.50 an hour, which is in some cases 50 percent higher than that of nonunion rivals. Thus, the union's choice appears to fall between delivering for the members and drastically complicating its bargaining structure. The logical solution seems to be a moderate compromise with no strike—if the rank and file allows it. Our guess is that they too will see that a threat to industry bargaining is also a threat to them in the long run."

Jackie Presser acknowledged the pressure that industry-wide bargaining is under, and said its source is deregulation:

"Nearly 100,000 of our members are out of work in the trucking industry. According to the American Trucking Association, 350 large carriers have failed since the implementation of the Motor Carrier Act of 1980 (the legislation deregulating trucking). Deregulation has exacted a tremendous price in human terms from Teamster members, and as an economic experiment it is a failure.

"Devastated by deregulation, the trucking companies sorely needed the wage freeze we negotiated in 1982, and our members made the sacrifices necessary to help the companies. Outrageously high health-care costs have forced the additional sacrifice of diverting the members' annual cost-of-living increases to the health and welfare and pension funds. Our members are looking forward to a wage increase this time, but they realize they are dealing with a crippled and realigned industry and their demands are reasonable. The bottom line is job security. The threat of job loss has been like a cocked pistol held to the heads of Teamster truck drivers since deregulation started. We have given the companies wage relief, now our members need a little relief in their overly tightened belts."

David Lewin noted:

"In trucking, the major issues will be decentralized versus centralized bargaining, the regionalization or localization of pay rates, and responses to the nonunion trucking sector. I also expect that changes in work rules will be sought by employers. An issue that may affect both parties is an attempt by the Congress to strengthen incentives for states to enforce the 55 mile per hour speed limit, although countervailing forces support-

Table 2: Events on the Collective Bargaining Calendar for 1985

Month of Contract Expiration	*Industry*	*Company or other detail*	*Union*
January	Food	Sugar Companies, Hawaii	Longshoremen
	Transportation Equip.	AMC, Ohio, (Wisconsin in Sept.)	Auto Workers
	Retail	R.H. Macy & Co.	Retail, Wholesale, Dept. Store Union
	Textile	Burlington Industries	Clothing & Textile Workers
	Transportation	S. California Rapid Transit	Transportation Union
		Eastern Airlines (also April, May)	Machinists (Transport Workers, Pilots)
February	Communications Media	Television basic contract	Writers Guild
	Retail	Stop and Shop Supermarkets	Food & Commercial Workers
March	Transportation	Trucking Management Inc.	Teamsters
		Motor Carrier Labor Advisory Council	Teamsters
		Cartage Exchange of Chicago	Chicago Truck Drivers (Ind.)
	Retail	Bloomingdale Brothers	Retail, Wholesale, Dept. Store Union
	Food	Anheuser-Busch, Inc..	Teamsters
	Transportation Equip.	Budd Co.	Auto Workers
	Utilities	Commonwealth Edison Co.	Electrical Workers (IBEW)
	Construction	Local multiemployer contracts expire throughout March-July period	Construction Craft Unions
April	Rubber	Firestone, Goodrich, Goodyear, Uniroyal	Rubber Workers
	Hospitals	Affiliated Hospitals, San Francisco	Service Employees
May	Clothing	Clothing Manufacturers Association	Clothing & Textile Workers
		New York Coat and Suit Assn.	Ladies Garment Workers
		Affiliated Dress Manufacturers, Inc.	Ladies Garment Workers
	Hotels	New York City Hotel Assn.	New York Hotel & Motel Trades Council
	Paper	Contracts expire at many paper plants throughout May & June	Paperworkers
	Textiles	J.P. Stevens; Cone Mills; Dan River (June)	Clothing & Textile Workers
	Transportation	San Francisco Employers Council	Teamsters
June	Electrical Equip.	General Electric (Westinghouse in July)	Electric Workers (IUE, UE, IBEW)
	Transportation	Trans World Airlines	Airline Pilots
	Shipbuilding	General Dynamics	Metal Trades Council
	Food	California Processors, Inc. & Frozen Food Employee Assn. (Cal.)	Teamsters
	Retail	Jewel Food Stores	Food & Commercial Workers
	Service	Seattle Area Hospital Council	Washington State Nurses Assn.
	Utilities	Union Electric Co. (St. Louis)	Electrical Workers (IBEW) & Operating Eng.
		Georgia Power Co.	Electrical Workers (IBEW)
July	Communications	Western Union	Telegraph Workers
	Utilities	Pennsylvania Power & Light Co	Electrical Workers (IBEW)
	Communications Media	Alliance of Motion Picture & Television Producers (Los Angeles)	Theatrical Stage Employees
August	Electrical Equip.	Raytheon Co.	Electrical Workers (IBEW)
September	Food	Morrell, Swift, and Wilson	Food and Commercial Workers
	Transportation	American Airlines	Transport Workers
	Finance	Prudential Insurance Co.	Food & Commercial Workers
October	Glass	Libbey-Owens-Ford	Aluminum, Brick, & Glass Workers
	Transportation Equip.	Chrysler Corp.	Auto Workers
November	Aerospace	Pratt & Whitney, Aircraft Div. of United Tech.	Machinists
		Hughes Aircraft	Carpenters
December	Utilities	Southern California Edison Co.	Electrical Workers (IBEW), Utility Workers
	Electrical Equip.	RCA Corp.	Electrical Workers (IBEW)

Source: Bureau of Labor Statistics and Bureau of National Affairs, Inc.

ing removal of this legislation may well develop in 1985. In any case, labor and management in the trucking industry cannot ignore this issue, given that the absence or presence of the law as well as its enforcement can affect firm performance, employment and employee compensation."

Mr. Presser, aware of the issue, stated:

"In the interest of safety for the truck driver and traveling public, I am also concerned that, in the event of the 'sunset' of the Interstate Commerce Commission, all of the Commission's responsibilities for overseeing the safe transport of goods be transferred to an appropriate agency within the Federal Government—an agency that has sufficient staff and funding to pursue these safety requirements aggressively. I would not want issues of truck safety to be submerged in general concerns about highway safety. The special concerns of truck safety are, to a large extent, different from general highway-safety problems and warrant special attention by whatever oversight body will have jurisdiction."

Rubber bargaining was one of the earliest examples of pattern fragmentation in 1980.[1] Now, according to Earl Royse:

"Successful proposals for union concessions did not end with recession. Producers have negotiated changes in work rules to allow greater use of their facilities. One major change has been conversion to seven-day-a-week operations, with employees working on weekends at straight time whereas they previously received time-and-one-half on Saturdays and double time on Sundays. At General Tire & Rubber's plant in Charlotte, N.C., this was achieved only after a 4-month strike. About half of the workers received immediate pay increases. Not all union locals have gone along with this trend, but the seven-day workweek is becoming much more common in the industry. The moral of the story is that even if the statistics begin showing rising wage rates, these may well be offset, or more, by work-rule changes and other concessions that show up only in productivity figures."

David Lewin explained the continuing concessions:

"The rubber industry will continue to experience both international competition in the rubber-tire market and domestic competition from firms in the plastics and petrochemicals industries that produce products which, in some cases, act as substitutes for rubber products. Hence, the rubber industry will face ongoing pressure for labor (and other) cost containment. I expect this to translate into company bargaining objectives that include small rates of pay increase, no changes in fringe benefits, increased flexibility in work rules, freedom to subcontract work, and freedom to close and relocate plants. The United Rubber Workers will probably seek some job security through retraining and income-guarantee provisions, in return for agreeing to one or more of management's bargaining goals."

[1]For examples, see Audrey Freedman and William Fulmer, "Last Rites for Pattern Bargaining." *Harvard Business Review*, March-April, 1982, p. 40.

In his comments on this subject, Robert Neylan coupled the rubber bargain with the General Electric and Westinghouse negotiations:

"I think that the dominant effort in the 1985 bargaining will be directed toward job security. Wages and benefits will be secondary in importance. The manufacturing industries that bargain in 1985, electrical and rubber for example, have undergone radical change during the past several years. Electrical manufacturers have recognized that fabrication and assembly can be separated without loss of efficiency. Thousands of assembly jobs have left the Northeast and settled elsewhere. You can't go into a Rio Grande border town without tripping over an electrical assembly operation run at lower cost, and with efficiency equal to the best New England has to offer. Advance notice of closing, severance arrangements, and retraining programs have to be high priority subjects for bargaining. The real issue is whether they will have any effect—or has the horse already left the barn?"

Dan Mitchell wondered whether the electrical equipment companies will try to obtain concessions now, and be resisted:

"GE must be wondering whether it missed out on something in recent years. It bargained through the concession era in 1982 as if nothing had happened. GE has a reputation for shifting bargaining tactics when the moment is opportune. Perhaps, like the hotel owners in Las Vegas, they might want to 'test the waters' to see whether some belated concession might be obtained. If so, this could lead to confrontation."

The panel was asked if the steep concessions in construction during 1982-1984 were at an end. Mitchell said:

"Construction has been the heartland of concession bargaining. Someday the concessions will have to end. But the pace of concessions was so great last year that we thought that there were still some in the pipeline. The pace is still strong. And the UCLA business forecast does not project much employment growth in construction during 1985. Concession bargaining will taper off in construction, but there will still be some in 1985."

Robert Neylan reviewed the reasons for construction unions' loss of power:

"A major influence is the continued growth of the open-shop firms that are now doing as much as 70 percent of all building. The open-shop operators are expanding rapidly in commercial and industrial building, which formerly was exclusively union territory. Even in the face of a construction boomlet, union contractors will approach the table knowing that cost increases can't be passed through to owners as readily as they were in the 1960's and 1970's. The open-shop contractors are big enough and strong enough to take on practically any project.

"In the past, industrial unions used their strength to support their construction counterparts. An industrial company would think twice about letting a contract to an open-shop contractor because of the effect on its production workers. Now,

while there is ample capital available, no one is going to spend more than is necessary for a plant expansion, or a new plant, simply to appease a plant's production work force. Industrial workers have had enough problems of their own recently, and are not as likely to jeopardize their pay checks on behalf of brotherhood as they once were.

"Contractors were able to drive hard bargains in the past several years, extracting concessions and no-increase deals as a result of the recession. Most of the contracts signed in the recent past have been for one year and many will open in 1985. While business will be good in 1985, it will be down from the robust condition in 1984. The time of concessions is over in construction—but there is sufficient uncertainty remaining to induce caution on both sides of the table."

In discussion, one panel member observed that unions will continue to organize members whose wages are subject to forces beyond the unions' control. This will be the future of the U.S. labor movement. No one disagreed with this gloomy analysis of union power; the description of current bargaining seemed to verify it.

Public Policy and Legislation

The panel expects no major initiatives in legislation in 1985. However, it does anticipate major debate on tax policy. The tax system and its details are actually social policy—so the coming clashes in tax "simplification" will be public debates on social values and goals. Meeting two days after the reelection of President Reagan, the panel was unwilling to go much farther than the above statement.

One of the tax-supported income-transfer systems that is very close to the employment relationship is unemployment insurance, which has been buffeted in two deep recessions. The panel was asked: Will there be any changes made in UI in the relatively calm period they predict for 1985? The answer is "no."

Robert Neylan said the idea of voluntary individual accounts, to be used for job training in the event of layoff, probably will not be adopted.

"In view of the increasing concern over the deficit, I doubt that this concept, embodied in a proposed National Individual Training Account Act, has much chance of passage. Unemployment is a major national concern, but this type of legislation does not address the problem of the long-term unemployed, particularly those who have little chance of ever returning to their previous occupations because of structural changes in the economy.

"The Job Training Partnership Act, signed into law in 1983, has helped a significant number of participants to find work after completing the program. On the surface, at least, it is a successful response to unemployment although critics say that the program discriminates in favor of those who have skills, either by virtue of education or experience, upon which a new career can be built. Linking the unemployment insurance system to training would be costly—providing tax credits for participating employees and employers. Such a scheme helps only those who are equipped to take advantage of it. The hard-core unemployed, and those who don't have the background required for meaningful retraining, would be left where they were before—on the dole and without prospect of employment. Arguably, those who benefit from this type of plan have sufficient resources to land on their feet without any additional expenditure of government funds and without further intervention by government agencies."

However, he approves of income support during training:

"Candidates screened for participation in the Job Training Partnership program continue to draw unemployment insurance in some states, and I see no reason why this benefit should not be continued in similar circumstances. This simply recognizes the difficulty of concentrating on learning a new skill while eating your way through your savings. Care would have to be exercised to ensure that the training leads to a viable opportunity and that the participants are qualified and maintain standards of performance. The GI Bill of Rights was the most successful education-training program in U.S. history, but a small portion of its benefits were wasted on inappropriate activities which passed for education."

John Richardson advocated conditioning extended unemployment benefits on participation in a training program, specifically a National Job Training Partnership Act program. Presser agreed with him:

"Existing unemployment insurance regulations discourage individual efforts at retraining. If an unemployed worker is enrolled in a Job Training and Partnership Act program, or in other government or private training and education programs, that worker is 'unavailable for full time work' and, therefore, ineligible for unemployment benefits. This should be changed so that enrollment in training and education programs does not mean automatic ineligibility for benefits. Some consideration should be given to the trainee's willingness and ability to work full time while attending training and education classes."

In regard to the labor-relations laws and regulation by NLRB, the two academic panelists thought deregulation trends might extend to this legal byway. David Lewin said:

"I think that labor-law reform of some type is likely to occur in 1985. There is a possibility that some sectors now covered by the Taft-Hartley Act will be removed from coverage (construction, apparel manufacturing and trucking). There is also a possibility that airlines will be placed under Taft-Hartley; that is, removed from coverage under the Railway Labor Act. I believe that railroads will continue to be subject to the Railway Labor Act in 1985 in so far as labor relations are concerned, but the Act may be modified or streamlined, especially to reduce the time spent on mediation of labor disputes. This will depend in large part on the fate of other newly emerging legislative initiatives to deregulate the railroads as a sector of the economy."

Dan Mitchell said:

"A second Reagan Administration may not be content with simply making appointments to the NLRB; some future Presi-

dent could always appoint new people with different views. There will be strong pressure from within the Administration (not from major employers that are already unionized) to leave a legislative 'legacy.' The chances are that a sharp departure from the existing Wagner-Taft-Hartley framework would not get through Congress. But what would the Administration lose by trying?

"The official policy of the National Right to Work Committee is that it opposes compulsory union membership, not unions per se. So one line of attack might be a national 'right to work' law. But extending that logic could lead to an attack on the principle of exclusive representation. You wouldn't have to change much in the text of the Wagner Act—just a slight rewording of Section 9 would do it. Combine this with a slight rewording of Section 8, and employee representation plans (company unions) could be revived, perhaps as quality circles or productivity committees. In short, radical changes could be made in labor law with only minor rewording that would not appear radical. And it could be packaged with catch phrases about productivity, cooperation, consultation with employees, and so forth. Add to this brew recent statements by Lane Kirkland to the effect that the Wagner-Taft-Hartley framework has become an albatross and the possibility for a major alteration in public policy is enhanced.

"On the other hand, the Railway Labor Act is really a sideshow because of its narrow focus. Unless the unions and employers involved were anxious to change the law, why would Congress bother with it? No one has been perturbed for half a century by the fact that railroads and airlines are under a separate statute. Why should Congress get excited about it now?"

In discussion, the panel did not foresee major legislative attention to labor law in 1985.

Immigration control will come up again, and the panel thinks that this time a bill will be passed. Bob Neylan said:

"Three years ago, I thought that immigration reform hadn't a prayer of passing. At this point, it looks like an idea whose day has come."

Earl Royse added that "control by employment sanctions is probable." The panelists thought that passage would be easier in 1985, because there are no congressional elections until 1986.

Taxation of health-benefit contributions by employers as employee income will be proposed, but the panel expects it to be rejected. Bob Neylan said:

"Unfortunately, the outlook for legislation is fairly good. Its supporters sell it as a revenue raiser, a strong message in the face of a massive deficit. It is also viewed as a cost-containment measure since it will, presumably, reduce the demand for health services. The extent to which it will do either is pure speculation.

"The notion of taxing benefits at any level has so little appeal that it will be vigorously opposed by business, and by labor as well. The President might be able to force it through by arm-twisting since it appears that he is personally committed to the principle. There are better ways to raise revenue, and health-care cost containment is being addressed in the private sector with more vigor than in government."

Earl Royse suggested that some taxation of health benefits would pass:

"While there will be great debate over 'basic' tax reform, it is almost a certainty that proposals for significant broadening of the tax base will include employee benefits. Such tax debate will also be accompanied by massive lobbying efforts from corporations and the labor movement to protect the employee-benefits tax incentives that have been in place over the past forty years.

"Despite the debate and lobbying efforts, the growing deficit will probably force examination of all major revenue sources. Employee benefits will not escape, since they represent such a potentially enormous contribution to the base. It seems highly probable that a cap will be placed on untaxed employer health-care costs—with amounts above the cap taxed as employee income. If this is a likely outcome, the remaining question is 'How much of the employer's premiums will remain untaxed, and will they be indexed to the CPI?' "

After discussing this proposal for a while, the group concluded that tax policy on health benefits will not be changed, because so much opposition will develop. (The subject of voluntary employer and union health-care cost containment was fully discussed in Labor Outlook 1984, Research Bulletin No. 150, pp. 12-13. For this reason, the material is not reviewed here.)

Longer-Range Human Resource Issues

During its discussion of skill shortages, the panel remarked how widespread the report of unfilled positions has become. These anecdotal shortages are most often cited in technical occupations. However, panel members described a dearth of competent service workers as well—a shortage that is occurring in a labor market with 8.4 million looking for work.

This simultaneous shortage and oversupply of labor appears to be endemic, a "constant." However, the panel feels that it is growing. What are the causes? One is the likelihood that society is underinvesting in training and competence-enhancing education—and that the investments that are made are misdirected. A related problem—broadly stated—is a weak labor market "infrastructure." The information that should channel educational investment is lacking, so young people do not find and take appropriate scientific and basic skills training. Job market information is worse than fragmentary, it is misleading and out-of-date. The immobility of the labor force may be increasing from lack of a strong labor-market infrastructure. Young people take part-time service jobs in depressed areas, while jobs with major training components and career potential go begging in other areas of the country.

The panel raised this long-term problem, because of the felt presence of extreme inefficiency in labor markets. It

did not offer any resolution, nor did it lay blame anywhere. The problem seems certain to be raised again.

A second long-term issue discussed briefly by the panel deals with employee interests. A panel member observed that company "efficiency drives" are still strong and will continue as competitive pressure increases. At the same time, some counterpressures protecting employees from overzealous cost-cutting are disappearing. There has been a decline in occupational health and safety enforcement; a decline in equal opportunity enforcement. Union power is fading. Under these circumstances, are lower-level employees much more vulnerable to exploitation than in the previous two decades? The question was left hanging—but the panel has selected another long-term issue for the mid-1980's.

The short-term, 1985, outlook can be summarized as follows: a stable unemployment rate; wage increases slightly greater than in 1984, with inflation and unit-labor cost also slightly higher. No recession is foreseen for the next year. No major changes are expected in public policy, legislation or administration of the laws affecting human resources in the U.S. economy. Union decline will continue in 1985. Finally, competitive pressures on employers will sustain efficiency drives, even though the recovery is aging.

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The 1985 U.S. Economy: No Crisis, No Comfort

Summary of a meeting of
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Chickens Drifting Home to Roost

Edgar R. Fiedler

Meeting in the late Fall, members of The Conference Board's Economic Forum found themselves in more-than-usual agreement about prospects for 1985. Parts of the outlook—no recession and no outbreak of inflation—are reassuring. But other projections, such as a renewed rise in interest rates, further deterioration in the U.S. international deficit, and no progress on the budget front, are seriously worrisome.

As Forum members read the economic tea leaves, the current lull in the economic recovery—the "slowdown" or "pause" or "growth recession," call it what you will—is likely to give way to renewed but moderate expansion beginning in the first or second quarter of the new year. At the moment there are no signs that renewed growth is imminent, and thus a clear risk exists that, instead of regaining strength, the economy could fizzle out into a full-fledged recession. But the classic qualities of a culminating business cycle are absent: We see no evidence of serious cyclical maladjustments such as exhaustion of demand, overbuilt inventories, excessive investment, accelerating inflation, and the like.

To the contrary, several sources of strength are present to fuel renewed growth. Following the strikes of this past Fall, the scheduled increase in automobile production will, by itself, add 1½ to 2 percentage points to the first-quarter change in real GNP. Weapons production, which lagged for a while, is moving forward again. The decline in interest rates, which may continue for a while, is encouraging homebuilding and consumer purchases of other interest-sensitive, big-ticket items. Moreover, the economic lull coupled with the benign inflation picture have put aside the Federal Reserve's mandate for restraint, at least for now, and have left the monetary authorities free to be as accommodative as they might choose, pending further economic developments. Indeed, several of the Forum participants contend that the Fed is already actively embarked on this course. Another source of strength is to be found in the state and local governments, which are discovering that their budgets are in much better shape, and thus are stepping up their activities. And the financial position of consumers, while not as good as a year ago, is still basically strong. Consequently, there is wide agreement that a moderate pace of advance is the most likely prospect for 1985.

A strong consensus also emerged on the favorable outlook for inflation. Considerable slack exists in both product and labor markets. In internationally traded goods, competition is fierce and price levels are, if anything, falling. Despite the recovery, wage-rate changes have not accelerated and, in fact, may still be subsiding very slightly. Food and energy prices show no sign of making trouble. The productivity story is not encouraging, however. The gains of 1983 and early 1984 reflected the vigorous economic recovery of that period, but

Edgar R. Fiedler

Threat of starving the sources of productivity growth.

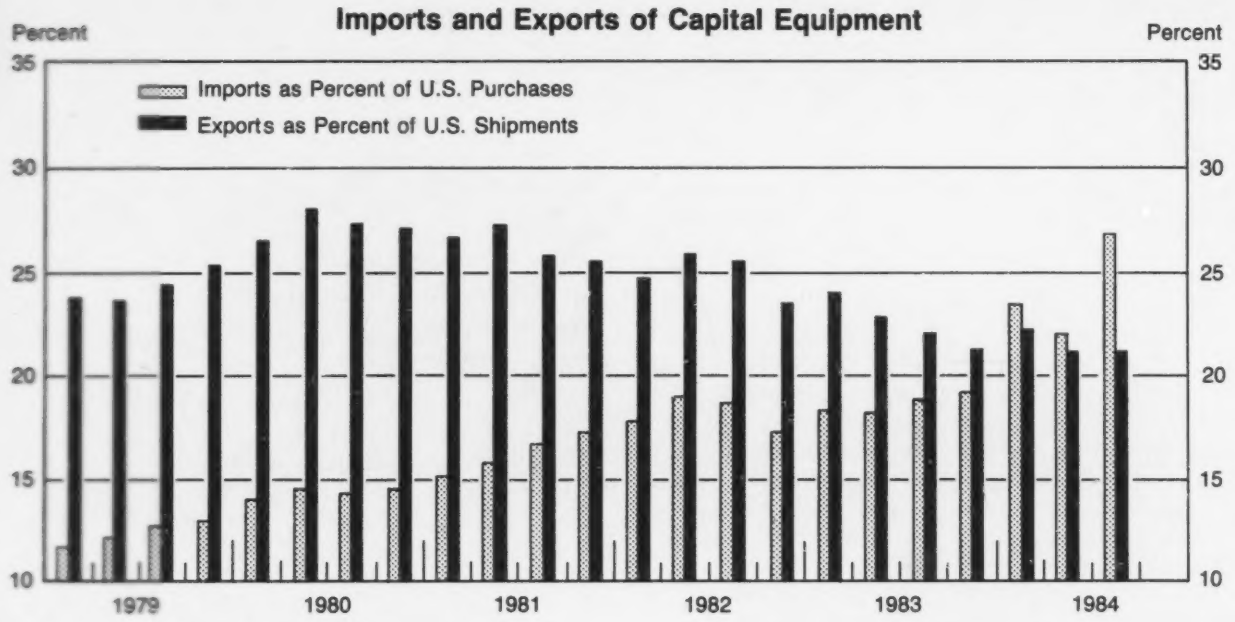
no more than that; thus there is no evidence that the underlying trend of productivity has accelerated from its desultory performance of the 1970's. Nevertheless, the inflation outlook is really quite good, even without help from efficiency gains.

The one risk on inflation is from the exchange rate. Because of normal lags, the sharp climb in the international value of the dollar through the late Summer of 1984 is continuing to have a dampening effect on the general price level. If the dollar should fall sharply, however, that downward pressure would wane and then become inflationary. But even if the dollar were to fall sharply now, the switch to upward price pressures would not be felt with any intensity until late 1985. Furthermore, Forum members are far from confident they can say where the dollar is headed: A majority guessed it would stay about where it is for the next year, but a sizable minority said it would be down markedly. In any event, the group agreed that the general price level would rise 4 to 5 percent in 1985 with no significant change in that trend during the year.

Most surprisingly, there is agreement—not unanimity, but a fair amount of agreement—that interest rates will rise again during 1985. Although some felt the recent declines could persist for a while, the general view is that, between now and the end of next year, pressures from an expanding economy coupled with the Treasury's enormous financing requirements will push rates a percentage point or two higher than they are today. In turn, those higher rates could bring on another growth recession in late 1985 or 1986.

Foreign Inroads

The international dimensions of the U.S. economy is a topic the Forum returned to again and again. It is these conditions, along with high interest rates, that are the major reasons why renewed economic expansion is expected to be sluggish and uneven in 1985, rather than vigorous and across the board.



Import penetration is ravaging employment and profits in industry after industry, especially in the Midwest, and the detrimental effects are fanning out to all sectors of the economy. How rapidly this is taking place in the machinery industry, for example, is illustrated by the accompanying chart. Another example, among many that might be cited, is computer-related supplies, where the United States had a huge international surplus 18 months ago, and today has a deficit. U.S. consumers are benefiting, of course, but the phenomenal speed at which our producers are losing markets is an extremely serious problem. The adjustment process cannot begin to keep up with it. Trade in the so-called "invisibles," such as net investment income and tourism, is shifting violently too. Albert Sommers quipped that he has been to Europe twice in recent months "without ever once seeing a European." Since the 1984 rise in the exchange value of the dollar has not yet been fully reflected in the marketplace, the worst may be yet to come in our trade and current-account balances.

David Devlin, our specialist on the debt problems of the less developed countries (LDC's), painted a relatively encouraging picture—encouraging compared to what is usually heard about this subject. For the most part, the crisis of the past few years reflected the severe worldwide recession of 1980-1982 and the absence of adjustment to those hard times by many of the LDC's. Today, by contrast, the world economy has turned around and the LDC's are, in fact, making the necessary adjustments. To the IMF and others who watch this problem, today's picture is entirely different from 1982. True, some bankers will continue to develop ulcers over it. But with both the world economy and the adjustment process looking good for 1985, Devlin sees the systemic threat to the international monetary system to be contained, at least for now. On the issue of long-term growth among the developing countries, however, he does not feel reassured.

Economic Policy

The discussion of policy focused on two issues. The most immediate is how the Federal Reserve responds to the current economic lull. As mentioned earlier, the group thinks the Fed has already, or soon will, adopt an appropriate policy—either actively spurring the economy back into the path of growth, or at least making sure monetary conditions do not stand in the way of renewed expansion.

The second and more compelling issue is the budget. All of us agree on the need to bring it under better control during the coming year as a crucial step toward reducing inflation expectations, easing pressures on interest rates, and achieving a better international balance.

In the simultaneous and circular process that so often characterizes economic relationships it is frequently difficult to separate cause and effect. This is surely true in the complex interrelationships among the budget deficit, interest rates, the exchange value of the dollar, and the deficit in our international accounts. Each of these is both cause and consequence of the others. Nevertheless, as Sommers put it, the best place to start is with the budget deficit as the basic, initiating cause of the high levels of interest rates, the value of the dollar, and our international deficit. Yes, there are other important contributing influences and many feedbacks within the system, but the budget is the lynchpin. Consequently, while there are surely different opinions within the group on some aspects of the budget issue—for example, whether policy-makers should aim to bring the deficit down to $100 billion or to zero, and just how to go about it—no one doubts that substantial movement on the budget is over-

The Forum Consensus
Results of a Pre-Meeting Outlook Survey

	Actual 1983	Estimated 1984	Projected Fourth Quarter 1984	Projected 1985 Median	Projected 1985 Range
Economic Growth (Real GNP, percent change)	6.3	5.2	1.8	3.0	2.0-4.0
Inflation Rate (GNP Deflator, percent change)	3.8	3.8	3.8	4.5	3.8-5.8
Corporate Profits (After taxes, percent change)	40.0	–2.9	–2.0	8.5	0-15
Unemployment Rate (Percent, average during fourth quarter)	10.6	7.5	7.5	7.4	7.0-7.9
Commercial Bank Prime Rate (Percent, average during fourth quarter)	11	11½	11½	12-3/4	10½-14

	Actual FY 1984	Median FY 1985	Median FY 1986
Federal Budget Deficit (Billions of dollars)	175	192	210

Note: These forecasts incorporate submission by Forum participants in late November, and are based on data available at the time. For growth, inflation and profits, the annual forecasts are the percent change over the four quarters of the year, i.e., from 1984 IV to 1985 IV; the forecasts for the fourth quarter of 1984 are at seasonally adjusted annual rates.

due and, as big as the task is, that action is required on both spending and taxes.

The coming year is an ideal time to tighten fiscal policy, not so much for immediate effect but to reduce the 1986 and future deficits in a substantial and lasting way. If fully credible, such changes would be good news for long-term interest rates in 1985, and helpful to U.S. exporters and all of us for years to come.

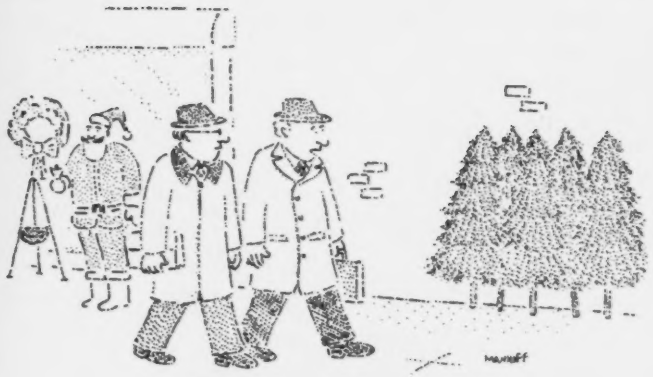
Easier said than done, however, and there is widespread pessimism among the group that meaningful budget action will be achieved in 1985. The American people don't see the deficit as a menace, and thus feel no urgency about closing it; the costs of chronic deficits are too uncertain, too distant and too complicated to be understood clearly. Yes, ask the people about the budget and they will say it should be balanced, but they do not believe severe measures are necessary to do so. In any event, (to cite what Amatai Etzioni called his "threepenny interpretation" of the public-opinion polls), they do not want to make budget changes that hurt. This is particularly true on the spending side, where the majority would prefer to have taxes raised rather than see social programs cut back—especially transfer payments to the middle class, which is where the big money is. On the tax side, the Forum members anticipate only some trimming of loopholes, including probably a minimum tax on corporations, but nothing in the way of big revenue increases. Some day we will have a crisis that will force the President and Congress to make the politically painful decisions needed to close the budget deficit—but not now.

Tax simplification and reform—that is, reform without raising revenues—is also a dead issue. Now that the Treasury proposal is on the table, along with Bradley-Gephardt and Kemp-Kasten, the modified flat tax may be talked about a lot. But talk is about all that can be expected.

Can it Last?

A budget outlook as pessimistic as suggested here, with massive deficits continuing as far as the eye can see, raises serious questions about the viability of current economic and financial conditions. The report on last Spring's meeting of The Conference Board Forum reached the conclusion that the oversized internal and external deficits together with high interest rates and an overvalued dollar are a combination that, over time, is fundamentally unstable. Indeed, the report was entitled *Unsustainable Trends and Hard Policy Choices* (Research Bulletin No. 162).

Well, the politicians (as is their wont) evaded the hard policy choices. But no crisis developed. The chickens did not come home to roost. They are, in fact, nowhere in sight. Both the economy and inflation are behaving pretty well.



"Yes, I'm somewhat depressed, but seasonally adjusted I'm probably happy enough."

Drawing by Mankoff; © 1984
The New Yorker Magazine, Inc.

In particular, the interest-rate explosion that was to have ignited when growing private credit demands collided with the Treasury's needs did not occur. Why? Because it turned out to be much easier than expected to get savings from abroad.

Were we wrong last Spring to label the situation "unsustainable"? Nothing in the current outlook says we are headed for a crisis. And it still seems true that no place else in the world looks as attractive for investment as the United States. Europe and Japan want trade surpluses. Consequently, savings from abroad continue to be available for the United States to use to finance half or more of its budget deficit. For now, at least, we have no basis for concluding that current conditions are not sustainable.

Sustainable for now, yes, and for 1985, quite probably. But the Forum members seriously doubt this can continue for a long time. None of us feels, in Robert Wade's words, that we can "learn to stop worrying and love the deficit." Over the longer term, the cumulative effects are unavoidable.

At some point, foreigners will lose their appetite for dollars. It has not happened yet, but one day they will decide their portfolios contain enough dollar-dominated assets, and they will stop buying more; maybe they will sell a few. Once that happens, the present seemingly stable balance of forces starts to unravel. The dollar's exchange value will decline, perhaps sharply. After a time, our export industries get relief, but inflation accelerates. And if the available supply of savings is reduced in the process, as seems quite possible, interest rates will rise. A few chickens will have come home to roost.

At home, chronic deficits carry several serious risks. One is the possibility that a recession enlarges the deficit still further and induces hasty and ill-timed measures to raise taxes and cut spending, which in turn exacerbate and prolong the recession. Another is the threat that, following the next recession perhaps, public acceptance of monetary discipline and high interest rates would gradually evaporate, and political pressure from elected officials would force the Federal Reserve to monetize the deficit, which would set off a serious new conflagration of inflation. A third risk is that long-term growth is slowed to a crawl either by widespread protectionism or by inadequate capital formation. Already we have seen, as James Tobin pointed out, that more than all the increase in economic activity from 1981 to 1984 was absorbed by consumption and government purchases. If continued, it would not be too many years before the absence of net new investment would starve out the sources of productivity growth.

None of these possibilities suggests a crisis in the sense of a cataclysmic event. A crisis could develop at any time, but it seems more likely that the economic troubles we reap from the current unstable mix of conditions will evolve gradually in what will appear to be a nonthreatening way. The chickens come home to roost, yes, but they drift back one by one, rather than the whole flock coming at once. And the nonthreatening nature of the process could prevent an effective policy response, which would be unfortunate. No matter how inconspicuously a longer recession or higher inflation or slower growth sneaks up on us, the impact is just as grave. A crisis could well be preferable, if it would evoke appropriate policy changes.

Concluding Comment

Was all of our discussion of the economic and financial outlook as gloomy as these last few paragraphs? No, not all. The overall tone was on the pessimistic side, perhaps, but not severely so (like the character in the cartoon). The attitude seemed to be that we have been through much of this before and did not enjoy it—nevertheless we did live through it without crisis. We expect the same for 1985, no crisis but no comfort either. And the discussion ended on a positive note when Robert Wade suggested the financial markets may have discounted much or all of the economic troubles that lie ahead. "Both stocks and bonds," he said, "offer reasonable returns over the next several years."

Reading the Public's Mind

Amatai Etzioni

The public entered the 1984 elections rather happy. People felt things were looking up for the economy, for the country, and for themselves. They rewarded the President, who at least presided over the celebration, and quite handsomely.

Meanwhile an age of reconstruction began in many social institutions. After declining in the 1960's, educational achievement (SAT) scores are beginning to rise. After twenty years of rapidly rising divorce rates, the dismembering of the American nuclear family leveled off in the early 1980's. *Both* major political parties dedicated their 1984 conventions to the family, social values and country. Patriotism is in; ROTC, even CIA recruiters, are back on the campus. Crime is down. Participation is up in all religious groups.

All this could cause a terrible societal hangover and worse, if the economy again falls into a considerable recession, unemployment rises, and/or inflation reignites.

In politics, attention focuses at the moment on the Democratic party shambles, and its sure-to-be-continued propensity for fratricide. Within the GOP, one should not disregard the movement to the right (remember Dallas 1984). A November, 1984 Gallup Poll found that the proportion of Americans who see themselves as "right of center" rose to a surprisingly high 37 percent. Thus, if things go sour in the country, a somewhat additional tilt in this direction is as likely, or more so, than a return of the pendulum to the liberal left.

Amatai Etzioni

The flat tax has little public support.

The Budget Issue

The public abstractly supports a flat tax and deficit reductions, but these readings of the public's mind are based on counting noses, not measuring the *strength* of feelings. Also, these questions ask for no sacrifices or "trade-offs." Once these factors are taken into account, it turns out that the public (1) is strongly *opposed* to closing most tax loopholes and (2) is unwilling to support major cuts in social programs *or* defense for the sake of deficit cutting.

It would follow that the flat tax, at least one without *many* exceptions, has little public support. Deficit reductions, especially via some "revenue raising" and "non-Draconian" cuts in spending, seem more plausible.

Sawtooth Pattern Ahead

Lawrence Chimerine

After a strong first half, the economy has essentially been flat since early Summer. Little or no increase, or even a small decline, for fourth-quarter GNP now seems likely, following the relatively small rise in the third quarter. This dramatic slowdown is the result of several factors that have now become less stimulative: (1) A substantial portion of the pent-up demand for new homes, appliances and other household durables, which was created during the previous back-to-back recessions, has now been satisfied. (2) Inventory investment has passed its peak. (3) The favorable effect of accelerated depreciation and other tax incentives on the growth of investment spending is tapering off. (4) Fiscal stimulus is declining.

In addition, the negative effects of a severely overvalued dollar are now beginning to outweigh the positive impact of lower inflation, and the increase in interest rates earlier this year, on top of already high levels, is having a more adverse effect on demand than earlier in the recovery.

Lawrence Chimerine

Most of the risks are on the downside.

A Recession in 1985?

Despite the speed with which the softness is accumulating and spreading, some pickup in economic activity is likely to begin during the next several months, reflecting: the declines in interest rates now taking place; the acceleration of military expenditures already under way; continued increases in spending by many state and local governments for road repair, maintenance and other public works; the likelihood that the inventory correction will not be too severe in view of still relatively low inventory/sales ratios in most industries; increased production in auto and related industries now that the GM strike has been settled; and still relatively low inflation (especially with the favorable outlook for food prices), high confidence levels, relatively low debt burdens, and adequate savings, which should combine to produce a rebound in consumer spending.

The magnitude of the pickup will be relatively modest, however, with increases in real GNP averaging no more than 3 to 3.5 percent during the first three quarters of 1985. New housing activity will remain below the levels of early 1984 because mortgage rates will still be well above historical levels, especially since initial rates on adjustable rate mortgages are not being as heavily discounted; and because a large supply of housing now exists, as reflected by the large amount of unsold new and existing homes on the market, and by rising vacancy rates for apartments and condominiums in many areas. The increase in consumer spending will be modest in view of the slower growth in wage and salary income. The increase in capital spending during 1985 will be far less than earlier in the recovery, reflecting the squeeze on profit margins being caused by the effects of the overvalued dollar and slower growth in productivity, the petering out of the impact of accelerated depreciation, and still high real interest rates. Even after the inventory liquidation process now under way is completed, inventory investment will contribute very little to economic growth. Net exports will continue to worsen during 1985 in response to the previous strengthening of the dollar.

Deficits and the Outlook

More moderate economic growth and an acceleration in military spending will cause the federal deficit in the current fiscal year to exceed the $195 billion experienced in FY 1983, following the marginal decline last year. Thereafter, these same factors, plus increases in the cost of many entitlements programs and rapidly rising interest expense, will combine to produce additional deficit increases in the absence of large new spending cuts or tax increases. These factors cannot be offset by strong economic growth—a significant decline in future deficits (on a current services basis) would require an average of nearly 5.5 percent per year real growth (implying 4 percent or more annual increases in productivity and/or unemployment below 3 percent by the end of the decade) and additional sharp declines in interest rates. However, historical patterns and recent trends make this extremely unlikely. Although some small spending cuts and/or tax increases might be passed next year, their impact on future deficits will be small relative to the total that is needed to alter the expected trend significantly.

While the better inflation outlook has caused some permanent improvement in the outlook for interest rates, even a modest pickup in economic activity will likely cause rates to start rising again in early 1985. The pressure for rising rates will also reflect the following. (1) Total credit demands and total debt outstanding continue to rise quite rapidly, despite the slowdown in mortgage and consumer installment borrowing. This in part reflects rising borrowing by the corporate sector in response to a widening gap between capital spending and the availability of internal funds. Private credit demands will rise further as the economy rebounds. (2) Money growth has temporarily lagged behind the growth in the monetary base in recent months because of seasonal adjustment and other technical factors (furthermore, the growth in reserves is now accelerating). Thus, it is likely that the money supply will grow more rapidly during the next few months. (3) Treasury borrowing will be enormous during the first half of 1985, and is likely to continue to rise thereafter. (4) Foreign purchases of U.S. financial assets are likely to slow from the recent pace. Thus, we expect most interest rates to rise by nearly 200 basis points from early 1985 through late Summer or early Autumn. This is likely to produce another sharp deceleration in economic activity in late 1985 and the first half of 1986, with the economy again flattening out during that period.

Thus, the period from mid-1984 through 1986 will be characterized by a sawtooth pattern, with periods of slowdown (which bring interest rates down) followed by some acceleration in economic activity (which will push rates up again). This implies relatively slow average growth. Furthermore, most of the risks are on the downside—in the near term, a sharper slowdown (or recession) will occur if inventories are reduced more sharply than now expected, or if consumer confidence deteriorates rapidly. Thereafter, the major risks to the forecast are that of a sharp decline in the dollar prior to actions to reduce Federal deficits (pushing up interest rates more rapidly than now projected), or that the adverse effects of large budget and trade deficits and a rising Federal debt/GNP ratio are even sharper than now expected.

Consumer and Housing Outlook

Allen Sinai

The U.S. economy appears to be in a growth recession, with a one-in-four chance of something worse developing. Little growth is occurring so far in the fourth quarter, particularly in the consumer sector. Weak spending on consumer durable goods and a sharp decline in net exports have reduced domestic sales, orders and profits, leading to a mild inventory cycle. Some paring back of capital outlays, attempts to reduce inventories, and caution on employment can be expected into early 1985. Although the classic signs of an impending recession are not present, the eventual playing out of these forces does not rule out such an eventuality.

For 1985, the most likely pattern for consumption is increased spending on interest-sensitive items such as automobiles and homes, as loan rates finally drop sufficiently to induce increased activity. Despite large declines of short- and long-term market-interest rates, mortgages and loan rate reductions have been substantially less. In addition, incentives to save and disincentives to borrow and spend in the form of extraordinarily high real and real-aftertax returns on saving and costs of borrowing seem to be encouraging a shift to saving from spending. (See table.) Given that the effects of the personal income-tax cuts of 1981-1983 are now waning and that a large portion of the pent-up demand by households for big-ticket items has been satisfied, growth in real consumption can be expected to be only 2.8 percent, compared with the 4.8 percent and 5.2 percent surge in 1983 and 1984. Housing outlays should also reflect a diminished propensity to consume, with starts at 1.55 million units next year, compared to the 1.77 million units of 1984. Underlying these expectations for consumer outlays is a reversal in the current downtrend of interest rates during the second and third quarters of next year, stemming from: (1) no resolution of the policy mix difficulties that have created the current slowdown; (2) sufficient reacceleration in economic growth to raise sharply the demand for money; (3) a still-huge volume of Treasury financing superimposed on renewed growth in private-sector credit demands; and (4) the discipline of the lower monetary-growth targets set for 1985 by the Federal Reserve.

Allen Sinai

Increased spending on automobile and homes.

Consumer Outlook

What the consumer giveth, the consumer can take away. After six quarters of strong spending and weak saving, especially on big-ticket items such as autos, houses, furniture, appliances and other durable goods, households finally cut

Nominal, Real, and Real Aftertax Interest Rates: Before and After the New Federal Reserve Policy (Averages for Period Indicated, Percent)

	Nominal			Real			Real Aftertax		
	1955-79:3	1979:4-84:3	1984:3	1955-79:3	1979:4 84:3	1984:3	1955-79:3	1979:4-84:3	1984:3
3-Month T-Bill Rate	4.6	11.0	10.3	0.2	5.4	11.0	–0.3	3.9	9.8
Mortgage Rate	7.2	15.0	15.0	0.4*	6.6	10.2	–0.6*	4.5	8.3
Prime Rate	6.0	14.6	13.0	1.9	9.6	12.6	–0.6	4.3	7.6
New Issues, Top Quality Loan Rate	6.2	13.1	12.5	2.8	5.4	7.4	2.0	3.6	5.8
24-Month Consumer Loan Rate	9.3	17.0	16.8	5.4	8.4	13.4	4.0	5.3	10.5
36-Month Automobile Installment Rate[1]	9.1	15.0	14.1	6.2	8.4	11.4	4.4	5.7	9.0

*1965-79:3.
[1]1957-79:3.

back in mid-1984. The reductions in consumption were concentrated in durable goods spending which, in real terms, was hardly different in October from January, 1984.

For the next year, consumption spending should continue to grow, particularly in the second and third quarters of 1985, but at a much slower pace, especially for durable goods. Nondurable goods spending and services spending should keep rising at a good clip. About a 1 percent rise in consumer durable outlays, in real terms, can be expected. Services outlays should be up some 3.5 to 4 percent. The personal savings rate should remain relatively high, by recent standards, at near 6.5 percent.

The main reasons for the renewed growth in consumer spending expected for 1985 are the lagged reactions to lower interest rates in 1984, a small tax cut from indexing, and improving balance-sheet positions as an outgrowth of the recent pause in spending and borrowing. Household incomes, net worth, and consumer financial positions remain basically sound, although not so strong as in recent years. Sentiment will worsen somewhat in the near term, but pick up as the economy moves through 1985. The key factors underlying this forecast include:

- Real disposable income: up 3.3 percent over the next year after the 6.7 percent rise of 1984. A small cut in taxes from indexing, about $7 billion, will help raise real disposable income in the first half of 1985; but growth will be much less than in 1983 and 1984.
- Sentiment: becoming more pessimistic at year-end with a rise in the unemployment rate and weak equity markets, but improving in 1985 as economic growth responds to an easier monetary policy.
- Loan rates: down another one-half to one percentage point for mortgages and consumer loans, helping to raise consumption by late in the first quarter of 1985. So far, loan rates have hardly responded to the large declines of market interest rates in recent months, so that buying financed by borrowing is not likely to turn up quickly.
- Consumer net worth: in real terms, a good but lesser rise of 4.8 percent in 1985, compared to 13 percent in 1983 and 6.3 percent this year.
- Household balance sheets and financial position: adequate, but the taking on of a considerable amount of debt during the period from second quarter 1983 to second quarter 1984 in order to finance durable goods will have some continuing negative feedback effects.

Housing

New-home sales and housing starts can be expected to respond to the downs and ups of interest rates. Housing starts are projected to fluctuate between 1.5 and 1.7 million units over the next year. Deposit inflows to lending institutions and mortgage finance should be ample, especially with the improved secondary market in mortgage finance. Heavy use of adjustable-rate mortgages will continue to make housing affordable for many American families.

Longer run, another pause in growth and lower interest rates in 1986 should establish a better base for stronger growth in consumption and housing later in 1986 and 1987. The major risk to this outlook is the possibility of sharply higher interest rates for 1985 or 1986, over a clash on the budget and/or uncertainty about Federal Reserve policy. Resolution of the policy mix problem in an obviously credible way, with a tightening of the budget followed by easier monetary policy, could drastically change the outlook for interest rates for consumer and housing expenditures. A shift toward a tighter budget and easier monetary policy that was clearly set to occur would lower interest rates substantially and reverse any weakness in consumption and housing. Another major downside risk lies in current tax reform legislation as it pertains to aggregate consumption, that is, risk of a negative effect on home prices and consumer outlays through increased incentives to save and the impact on household net worth.

Keynesian Shock II

Albert T. Sommers

The subsiding of U.S. growth from its enormously energetic level of the first half of the year was so widespread in the third quarter as to be obvious to all, including the Federal Reserve. It was visible not only in the sharp decline of real growth that now appears in the national accounts of the third quarter but also in all of the basic data on sales, orders and backlogs, in inventory policy, in the acceleration of delivery rates, in corporate profits, and in the renewed widening of the federal deficit. The crucial and culminating statistic in this emerging description of weakness was almost certainly the flash report on new orders in durables industries for October, which revealed a broad and general decline, including a sharp decline in capital goods orders in nondefense industries.

Most strikingly of all, the enormous decline in interest rates of the past several months has brought them to levels not anticipated in most models until fully six months from now. Most of the decline in rates occurred without visible assistance from the Federal Reserve; the monetary base, over which the Federal Reserve has substantial control, has risen at only about a 2-percent annual rate for the past months, and M_1, over which it has considerable influence, has experienced no growth at all. The most powerful reason for the decline in rates has been the continuing reappraisal of the inflation outlook, which was helped along largely by the stability of the price indexes themselves—a consequence of the ferocious competition with imports—together with a big assist from the weakness in petroleum prices.

The Federal Reserve is thus in about the position it might have expected to encounter in the Spring of 1985, and its latitude for action is now clearly enlarged. However much it must resent the fact that its efforts to restore growth to the system before any action is taken on the federal deficit will look like "monetization," because it will revive acquisitions of government securities by the banking system, the resulting outcries from pure monetarists will have to be ignored for a while. The more proximate danger is that even sluggish growth on the part of the U.S. economy would act to enlarge the federal deficit (as it is already doing), while at the same time it would reduce the likelihood of action by the Administration and the Congress to curtail expenditures and raise taxes.

The business weakness has removed the Federal Reserve's range of restrictive options; it is in a position to administer what might be called "Keynesian Shock II"—liberal provision of reserves, leading to at least moderately rapid growth in the money stock, in the presence of a very large budget deficit. Keynesian Shock I, of course, occurred in the Fall of 1982, in absolutely immense degree, and was responsible for the awesome rate of economic recovery that ran from

Albert T. Sommers

The Fed is again an ally of growth.

early 1983 into the middle of 1984. The Federal Reserve, at least temporarily freed from its inflation concerns by the stability of prices and by the apparent weakness of U.S. markets, is again inevitably an ally of growth. Even in the presence of the budget deficit (however bewildering it is to find weakness in the presence of such a deficit) its behavior for the next six months will be seeking a recovery in U.S. markets, and *then* controlling it when it occurs.

The conditions under which Keynesian Shock II will be applied are different from, and more cautionary than, the conditions that applied in the Fall of 1982; the application, and the outcome, and the duration, are all likely to be more moderate. This time around, there are some big actual differences in the situation, as well as putative differences in the probable consequences. For one thing, business inventories have been accumulating rapidly, whereas they were in gross liquidation at the time of Keynesian Shock I. The whole system is much nearer high employment, and the budget deficit, while it is smaller in dollars than it was in late 1982, is now almost totally *structural* rather than *cyclical*. The aggregate rate of debt incurrence by nonfinancial sectors is already positive, as contrasted with sharp negative change in the Fall of 1982. Operating rates in business are at 82 percent of capacity, not 68 percent. In Shock I, the system was still generating volumes of deferred demand; this time around, the cyclical phase of the system has been at high levels for a year, as it recouped the demands deferred out of 1981-1982. Shock I had to turn the whole system from deep recession to expansion; Shock II simply has to reinvigorate a system that has consumed a good deal, but not all, of its natural cyclical opportunities. And, finally, and most problematically of all, the dollar is fully 25 percent higher than in the Fall of 1982; the trade deficit is six times greater, the deficit on current account is also about six times greater. Nobody, but nobody, knows the true size and direction of the capital inflows that necessarily accompany the current account deficit, or their ultimate sensitivity to declining U.S. interest rates. But the spectacular imbalance in the

U.S. international account would certainly seem to limit the opportunities for expansionary policy at home.

Under these circumstances, what does the Federal Reserve do, and what are likely to be the consequences of its actions? The very sharp declines in interest rates from their peak in July—now covering the discount rate and the prime rate, as well as virtually all market interest rates—has been virtually entirely a consequence of market conditions, not of Federal Reserve action. They are traceable to the rapid decline of the U.S. economy into an uneasy and suggestive pause; and to a precipitous decline in the perceived present and probable future rate of inflation. Such paradoxical developments—the slowing of growth, the low inflation, the comfort in capital markets in the presence of a gigantic budget deficit—are all consequences of the U.S. international position, which has provided a flood of imports to brake industrial growth and severely restrain inflation, while providing the capital-market inflows required to keep peace in financial markets even in the presence of the budget deficit. It is a reasonable conclusion that the Federal Reserve has a range of options capable of generating a modest-sized Keynesian Shock II and that it will take that opportunity now.

Challenges to Policy

James Tobin

Two difficult challenges confront macroeconomic policy in 1985. The immediate challenge is to keep the recovery going; this is the task of the Federal Reserve. The longer-run challenge, to the Administration and Congress as well as the Fed, is to shift the policy mix to a much tighter budget and an easier monetary stance, lowering interest rates and the foreign exchange value of the dollar.

The Fed has succeeded in slowing the recovery. Volcker & Co. so wanted a soft landing that they may be bringing us down short of the runway. As unemployment and excess capacity reports show, the economy is still slack. Inflation is quiescent, and the monetary aggregates barely exceed the lower limits of the Fed's target ranges. The Fed appears to be cautiously exploiting the opportunity to ease. Its task is not just to avoid outright recession but to overcome the incipient growth recession. This is a delicate operation; the degree and speed of monetary easing will be tempered by the Fed's chronic worries about inflation and its fears of a disorderly fall in the dollar. The greater risk is that the Fed will be too cautious and too sensitive to less favorable news from price indexes and exchange markets.

The coming year is the ideal time for the President and Congress to take actions to arrest the runaway growth of federal debt relative to GNP, to take actions that would take effect in 1986 and later years. Such legislation would help the Fed meet its immediate challenge; interest rate reductions in 1985 would be more effective because they could be expected to be permanent. But it seems unlikely that fiscal corrections will be adopted next year. During the 1984 electoral campaign the President committed himself strongly against tax increases and other measures without which little reduction in prospective deficits is arithmetically possible. He remains wedded, it seems, to the strategy of using budget deficits as a weapon for cutting civilian social spending still further, a strategy the Congress is bound to oppose.

James Tobin

1985 is a critical year for policy.

Should the economy slip into recession despite Federal Reserve efforts to the contrary, projections of deficits and debt will become frighteningly larger. Not only will anti-recessionary fiscal measures be unthinkable, but ill-timed and counterproductive fiscal restrictions may be voted in panic. This is another reason why 1985 is a critical year for policy.

On the LDC's, Banks and Ulcers

David T. Devlin

Most of my time the past few years has been spent thinking about the less-developed countries (LDC's) and whether or not they and the banks are going to go broke. In the process I have had to assume some kind of world economic environment in which they operate. My current prejudices follow:

	U.S.		Seven Major Countries	
	1984	1985	1984	1985
Real Growth, percent	6	3	5	3
Inflation, percent	4	5	4	4
Current accounts, $ bill.	-85	-100	-33	-40

In real terms, both U.S. interest rates and the value of the dollar have been too high for too long for my theoretical (mostly monetarist, but pragmatic) taste.

I was impressed over the last few years by both the Republicans and the Democrats being in favor of reducing the budget deficit. And I believe they were sincere. As I said before the election, I hope one of them wins and reduces the deficit. But which is it to be: increased taxes, reduced military spending (Democrats) or reduced "entitlement" programs and a boost from growth (Republicans)? There was a deadlock and less of one, but still one, continues. I bet even money on a reduction of some $50 billion by 1987.

Now let's turn to the U.S. balance of payments. Last century Bank of England observers reportedly said that 1 percent on the bank rate brings money from the moon. The United States has demonstrated they were not kidding. In 1984, our budget deficit is $170 billion; our current-account deficit is $85 billion. Some 50 percent of the net budget deficit is financed from abroad. If you look at gross inflows, it's more. Developed countries like the United States are supposed to be capital exporters. Something is funny, but I expect and hope it's only temporary.

Now, what can be said about the banks and less-developed countries? The LDC debt crisis reflected two factors: the horrific world economic environment of 1980-1982, and inadequate adjustment, at least initially, by the developing countries to that environment. As a result, some 32 countries rescheduled debt over the last few years, some a number of times. It was almost inevitably done in the context of an IMF program that required the country to adjust, and as part of which the lending banks put up some new money, mostly nonvoluntarily. Today, the world economic environment has turned around: OPEC has gone into deficit, and the current-account deficits of non-oil LDC's have dropped from $110 billion in 1981 to some $45 billion now. Thus, they *are* adjusting.

How about the future? Both the world environment and the adjustment process look OK for 1985. In 1986-1987, a "wall" of amortization is approaching. However, if a country is adjusting, a multiyear rescheduling can magically flatten the wall, as in Mexico for example. Keep in mind the fact that no one—not the LDC's, corporations or the U.S. Treasury—is expected to actually pay off its debt, only to keep it from rising at a more than sufficiently modest pace.

David T. Devlin

The LDC's are adjusting.

Along with the revival of growth in the major industrial countries and the impact on commodity prices and imports, economic growth is now recovering in the developing countries. There is always a lag in the perception of a turnaround, but even then the political-social tensions in the LDC's appear manageable.

There are still major problems: Countries that either don't have a functioning IMF plan and need it, or absent which there are doubts about whether they will continue to follow it. Although many bankers and officials will continue to get ulcers over these countries, the systemic threat to the international monetary system has been contained, at least for now.

What is not assured is longer term development and the structural adjustment required in the LDC's, if they are to increase real per capita GNP in the long run. If the fiscal-monetary-exchange-rate policies necessary to manage their liquidity are appropriate—well, that is a necessary condition for development but not a sufficient condition. Countries can be perfectly solvent and creditworthy, and have quite inadequate development.

For development, a whole range of other policies comes into play: Internal price incentives so producers have an incentive to produce; removal of various internal, administrative distortions; incentives for domestic saving and for foreign direct investment. There is lots to be done here. Perhaps if some combination of the World Bank, official agencies, country officials, and the banks could develop an adequate monitoring of this process, the world community could work out a way to get the funds moving that are necessary to finance such development.

Inflation and The Budget

Barry Bosworth

The inflation outlook for 1985 is extremely optimistic. No threat of acceleration exists in the United States. Labor markets are weak and wage-increases are, if anything, still softening a bit. Nothing in the economic outlook expressed here would change these prospects. The same can be said for food and energy prices, which are likely to remain quiescent. Thus I expect inflation to hold in the 4 to 5 percent neighborhood through 1985.

An interesting implication of the current forecasts for slower economic growth in 1985 is that it probably reduces the prospects for significant actions to reduce the federal budget deficit. While we are used to thinking of the economy as depending importantly upon the governments' fiscal policy, legislative budget actions today have themselves become dependent upon the course of the economy. The reason is that the public discussion of budget issues in recent years makes clear that no significant deficit reductions can be agreed upon short of a major economic crisis. Such a crisis would force the President and the Congress to compromise their differences and undertake a package of both tax increases *and* expenditure reductions. Short of such a crisis, much as Americans dislike budget deficits, they are more opposed to the sacrifices that would be required to resolve the deficit problem.

In prior years many economic forecasts projected that the budget deficits would ultimately generate just such a crisis. The government deficit continues to absorb well over half of net private saving. That was expected to curtail sharply resources for private investment. That was also expected to force very high interest rates or, if the Federal Reserve attempted to avoid the financial crisis of much higher rates by expanding the supply of credit, accelerating inflation. But neither higher interest rates nor inflation appear in the forecast for 1985. The basic reason is that it has proved far easier than anticipated to finance both the budget deficit and a high level of domestic investment. The magnitude of the net borrowing from foreigners, the current account deficit, now exceeds $100 billion annually or 3 percent of total national output.

Barry Bosworth

No significant budget action without crisis.

The outlook for 1985 is that, while the budget deficit will not decline, it will not increase as a share of GNP, and surveys of investment plans indicate a slowing of the investment boom. Thus, there is no increased pressure on the financial markets and the current situation can be sustained as long as the United States can borrow about 3 percent of GNP overseas—a trade deficit no larger than in 1984.

In fact, it appears that this balance could be maintained in 1985 and allow interest rates to decline. Lower interest rates in the United States may not put downward pressure on the exchange value of the dollar because European countries, desperate to join in the recovery, are likely to match any U.S. interest rate decline to stimulate their own economies. In addition, Europe is increasingly dependent on a large U.S. trade deficit to support its efforts to achieve an export-led recovery. Finally, the rapid deterioration of the U.S. trade deficit implies that the exchange rate is higher than necessary to balance saving and investment. A small decline of the exchange rate would still imply a sufficiently large trade deficit. Thus our economic forecast should lead us to reduce our expectations of significant budget actions.

Capital Market Outlook: Uncertain and Unstable

Daniel S. Ahearn

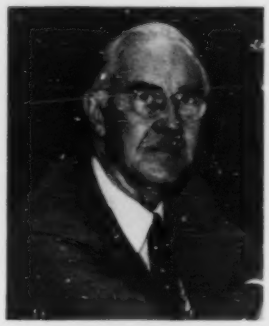
The recent slowing of the economy, still subdued inflation pressures, and an easier Federal Reserve monetary policy have improved the tone of the capital markets. Equity prices have risen modestly from summer lows, bond prices are significantly higher, mortgage interest rates lower. But the markets now face a confusing variety of challenges that suggest great uncertainty at best and the possibility of significant decline or even crisis at worst.

Where the capital markets go from here depends on five related factors: First, whether the economy recovers from its current sluggishness or weakens further into recession. Second, whether government makes progress in correcting the two great threats of unprecedented deficits in the federal budget and in the U.S. international trade account. Third, what happens to the dollar. Fourth, whether inflation remains subdued. And fifth, what happens to the tax reform proposals which threaten to change some of the most important elements of the framework of the capital markets.

There are grounds for optimism on the near-term economic outlook. The current slowdown is typical at this stage of an expansion and the normal subsequent reacceleration should be helped this time by a rebound from the two auto strikes at GM. Most importantly, government policy has become more expansive. Monetary policy has eased significantly at the same time the budget deficit has begun to rise more rapidly. Capital goods orders may be accelerated to hedge against possible loss of the investment tax credit. All this should permit an early end to inventory reduction efforts and offset much of the drain of U.S. buying power into imports.

Unfortunately, the outlook for correcting the massive deficits in the budget and U.S. trade account is not positive. The presidential campaign left a legacy of commitments that is negative for the federal budget. Mr. Reagan ruled out tax increases, any slowdown in defense spending and reduction in social security benefits, leaving only 30 percent of the budget to be cut. But Congress feels that nondefense and nonentitlement programs have already been cut severely. Thus, the odds favor little progress on controversial legislation, including the tax reform being advanced by the Reagan Administration. Moreover, regardless of how much actual change eventually occurs, the capital markets will be buffeted by hopes and fears as to what might be changed in the tax framework. Meanwhile, high budget deficits are likely to continue unless action is forced by some kind of crisis.

Budget deficits that add to the demand for funds and tend to raise interest rates are a major negative for the capital markets. They also risk serious longer run trouble by diverting too much of the U.S. savings flow from private investment, the source of economic growth and cost reducing productivity gains. Continued large budget deficits would likely make the economy both sluggish and inflationary. They would also encourage continued large imports of foreign goods, implying that our record trade deficit would likely persist or increase.



Daniel S. Ahearn

An ever present risk of crisis in the markets.

Whether the dollar would remain strong in this context is doubtful. Currently, sentiment toward the dollar is positive, despite an overload of dollars in the world's currency portfolios. But it would seem only a matter of time until the roughly $150 billion a year outflow in prospect for 1985 and later as a result of the trade deficit overburdens the willingness of foreigners to hold dollars and undermines the current positive psychology. Reliance on a continued positive psychology to keep the dollar strong is risky.

A weaker dollar could have sizable consequences. For one thing, the strong dollar has had a major effect in holding down inflation. It is estimated that each 10 percent rise in the dollar has reduced the U.S. rate of inflation by 3/4 to 1-3/4 percent. If the dollar should weaken, the U.S. inflation rate will worsen accordingly.

Moreover, foreign financing of our credit and capital markets has amounted to 2 to 3 percent of U.S. GNP and 15 to 20 percent of gross U.S. investment. The impact on interest rates of a lessened willingness of foreigners to supply funds could be important. Outright disorder in the currency and capital markets could develop if foreign investors try to reduce or eliminate their dollar holdings too quickly. While the Federal Reserve might supply funds to offset such currency shifts, official support operations could conceivably worsen the problem by raising fears of further inflation.

All this suggests a highly uncertain and unstable capital-market outlook. The economy should be rising but in 1985, fears of recession in 1986 might well rise. Inflation will remain moderate but on a gently rising trend with vulnerability to acceleration. Continued high budget and trade deficits will challenge the capital markets and inhibit the economy's performance. The current strength of the dollar may be succeeded by increasing instability with a downward bias. There will be an ever present risk of some kind of crisis in the capital and/or exchange markets and at some point, difficult to time, this risk probably will become actuality.

Equities: Moderately Undervalued But Not Compelling

Robert G. Wade, Jr.

Interest rates have fallen significantly. This has somewhat reduced the attraction of bonds and money market instruments vis-a-vis equities, a plus for the stock market. Just as important for equity market prospects, the lower rates, while symptoms of a currently weak economy, should be a factor leading to stronger economic growth later.

Interest rate drops of the magnitude witnessed since May have historically always been bullish for equities (absent a depression). For example, Federal Reserve discount rate cuts, which are a non-event in that they generally follow rather than lead rates, do confirm that the economy is weak and/or the Fed is easing policy. Such an environment leads to rebuilding of liquidity and is a favorable sign for stocks. The accompanying table demonstrates the bullish significance of initial discount rate cuts.

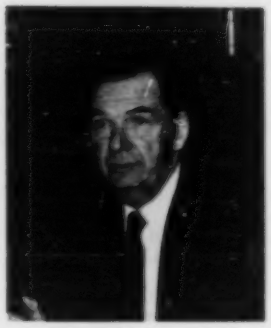
While economic growth may be below par for a couple of quarters, we do not expect a recession. The Fed has not had to worry about inflation, which has allowed it to ease more quickly at signs of an economic pause. Economic growth should move back to approximately trend levels next year, in the Spring or even sooner. The equity market would typically begin discounting the improved situation well in advance of the event. Over the shorter term, lower economic growth could give investors concern about corporate profits, but the lesson of history is that the favorable implications of lower interest rates win out over such concerns.

There is a decent probability of recession in 1986. Monetary policy should tighten later on in 1985, if the economy does get back on track. If a recession has to occur, the administration may prefer 1986 to a date approaching the 1988 presidential election.

Initial Cuts[1] in Federal Reserve Discount Rate and Subsequent Equity Market Returns 1951-1984

Month of Reduction	Total Returns of S&P 500 over subsequent periods		
	3 mos.	6 mos.	12 mos.
July 1953	0.5%	8.6%	31.9%
Nov. 1957	(1.1)	7.8	30.8
June 1960	7.5	8.1	13.5
Apr. 1967	1.6	1.4	7.2
Nov. 1970	11.8	16.0	11.2
Nov. 1971	14.2	18.2	27.7
Dec. 1974	22.9	41.8	37.2
May 1980	11.4	29.4	25.0
Sept. 1981	7.0	(0.7)	10.0
Nov. 1984	?	?	?
Average	8.4%	14.5%	21.6%

[1]Initial is defined as the first reduction in the discount rate after a previous increase or increases.

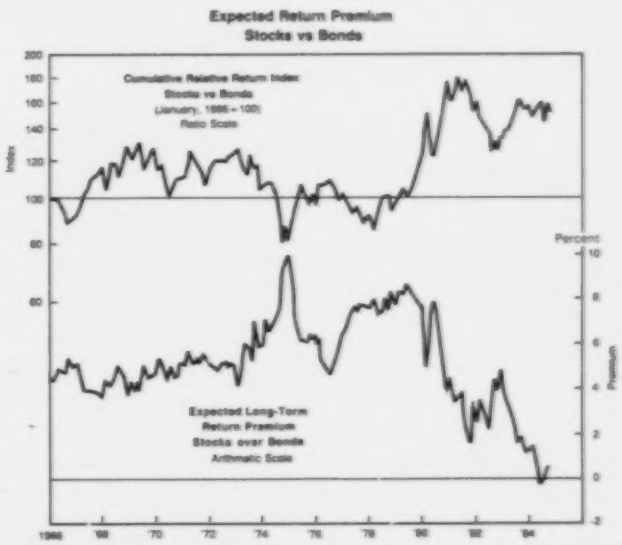


Robert G. Wade, Jr.

Both stocks and bonds will provide attractive returns.

Valuation

Equities are moderately undervalued in an absolute sense. Price/earnings ratios are low, and the earnings are not being distorted by inflation. Compared to bonds, however, equities do not seem compelling, despite the drop in rates which has occurred and the good relative performance of bonds that has resulted. Specifically, our current long-run expected return for equities is about 12½ percent (inflation assumption 5½ percent), which compares with current government bond yields of about 11.3 percent. This 1.2 percent premium, while improved over the negative premium existing a few months ago, is still an historically low number (see chart).



Sentiment-Supply-Demand

For the year ending June, 1984, pension funds for apparently the first time have, on a net basis, put no incremental cash flow into equities and, in addition, have sold stocks to buy bonds. This is a longer-term positive for equities as it increases the capacity of pension funds to buy more stocks in the future. However, given the narrow stock-bond premium referred to previously, this potentially bullish factor may not emerge until the apparent incentive to invest in equities is greater.

Speculative interest in the market has waned. For example, equity offerings are averaging $200 million weekly as against $2,000 million 18 months ago. Over-the-counter volume is down sharply. Sustained long-term bull markets have always been born in a similar apathetic atmosphere.

On a shorter-term basis, institutional cash reserve levels are apparently on the low side. Not coincidentally, perhaps, 75 percent of investment advisers are bullish on the equity market. Such "technical" conditions have not produced good equity markets in the past.

In sum, we feel that both stocks and bonds will provide attractive nominal and real returns over the next several years. On a more strategic basis (six to twelve months), the equity market is still vulnerable to correction. Consequently, we will be deploying our current cash reserves into the equity market only on weakness.

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Research Bulletin

U.S. Regional Economies

An Updated View of 1984-1985

number 174

The Conference Board

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This report contains brief updates of regional economic developments since the February 1984 meeting of the Conference Board's Regional Economic Forum. The proceedings of that meeting were published as Research Bulletin 161, *U.S. Regional Outlook 1984-1985*. At the time of that meeting, the economic news was unquestionably positive and the Forum members were encouraged. They expected good economic news to predominate in 1984, and that expectation has been met. But they were tentative in their assessment of prospects beyond this year, and that tentativeness persists in these updates. The Forum members have not been surprised by the economic slowdown since midyear and, in general, they do not see it as portending seriously unfavorable economic developments in 1985. But they are suffering the uncertainty and uneasiness that often afflict economic analysts when the economy is shifting gears.

Lora S. Collins
Director-Business Conditions Analysis
December 1984

New England

Lynn E. Browne*
Federal Reserve Bank of Boston

In the third quarter of 1984, the unemployment rate in New England averaged 4½ percent; the corresponding U.S. rate was 7½ percent. New England's low unemployment rate stems from the region's relatively favorable experience in the 1980 and 1981-1982 recessions. At the trough of the 1981-1982 downturn, in November, 1982, New England's unemployment rate was just under 8 percent, compared to a U.S. rate of close to 11 percent. Since then, both the U.S. rate and the New England rate have fallen by more than 3 percentage points. The persistence of such a large differential is unusual; regional unemployment rates tend to converge following a recession.

Employment growth during the recovery has been slower in New England than in the country as a whole. In the first recovery year, the difference was fairly modest. Stronger growth in the region in nonmanufacturing activities, especially trade, partially offset much weaker growth in manufacturing. Within manufacturing, the difference between the region and the nation was particularly striking in the durable goods sector and was due, in part, to the fact that the auto industry and its suppliers are less important in the region than in the nation. These industries suffered very severe employment losses in the recession but grew vigorously in the first year of recovery.

In 1984, growth has accelerated in New England's durable goods manufacturing industries, but remains below the national rate. The growth in the region is concentrated in electrical and electronic equipment, aircraft and shipbuilding, and nonelectrical machinery, which includes computers. A strong demand for investment goods and rising defense spending have contributed to the employment gains in these industries. Other durable goods industries have not fared as well and employment remains close to recession levels. Traditional metals and machinery industries face stiff foreign competition. New England's instruments industry, which grew very strongly during the 1960's and 1970's, also remains in the doldrums; among the causes are weak export demand and excess capacity in process industry customers.

Nondurable goods industries have grown very slowly in the nation in the past year, and employment has actually fallen slightly in New England. Although printing and several other nondurable industries have expanded in the region, the nondurables sector has been in decline in New England for many years. This trend seems to be continuing.

Nonmanufacturing industries also have grown more slowly in New England than in the nation in 1984, with the result that total nonagricultural employment has grown at substantially less than the national rate. All major nonmanufacturing categories have grown more slowly in the region. However, these figures should be viewed with caution. Such slow employment growth is consistent with the decline in New England's unemployment rate only if the labor force has also grown much more slowly in New England than in the nation. The labor-force statistics do not support this. In 1983, revisions to the employment figures, particularly for nonmanufacturing industries, showed New England to have grown much more strongly than the original numbers indicated. Perhaps the 1984 New

*The views expressed are those of the author and do not necessarily represent those of the Federal Reserve Bank of Boston or the Federal Reserve System.

Table 1: Percent Changes in Nonfarm Employment since Recession Trough—United States and New England

	Total	*Manufacturing*	*Durable Goods*	*Nondurable Goods*	*Non-manufacturing*
Recovery 11/82-9/84					
United States	6.8	8.5	11.7	4.0	6.3
New England	4.8	3.6	4.9	1.1	5.2
Connecticut	4.6	2.0	1.6	3.0	5.7
Maine	4.8	-0.9	2.4	-4.4	6.8
Massachusetts	4.2	3.7	5.4	0.0	4.5
New Hampshire	9.4	13.9	18.8	7.7	7.7
Rhode Island	4.7	6.1	6.4	5.6	4.0
Vermont	3.9	2.1	2.9	0.0	5.2
Year One 11/82-11/83					
United States	3.4	5.2	6.9	3.0	2.9
New England	2.8	1.7	1.7	1.9	3.1
Year Two 11/83-9/84					
United States	3.3	3.1	4.6	0.9	3.3
New England	2.0	1.9	3.2	-0.8	2.0

England employment numbers will also be revised upward. Certainly the Conference Board's Index of Help-Wanted Advertising suggests a healthy demand for labor in New England. The index has increased more sharply in New England in the past year than in the nation.

If the national recovery continues, the short-term outlook for New England is very favorable. Unemployment rates have already fallen to levels commonly associated with full employment. Wages are rising relative to those elsewhere. Despite the sluggish growth in manufacturing employment, average hourly earnings of manufacturing production workers have risen 11½ percent in New England in the past two years, compared with 7½ percent in the nation. For the longer term, a continuation of sluggish growth in durable goods manufacturing would be cause for concern. A decline in this sector played a major role in the deterioration in New England's economic position in the early 1970's, while vigorous growth later in the decade and a relatively strong performance in the recent recessions were critical to New England's subsequent revitalization.

"The Industrial Heartland"

Norman Robertson
Mellon Bank

Through the middle of 1984, the Industrial Heartland experienced a sustained and surprisingly vigorous recovery from the severe 1981-1982 recession. Essentially, employment returned to the 1981 level, and the region's unemployment rate reached a low of 9 percent in June. However, the economic pause that has gripped both the regional and national economies in recent months has caused a measurable decline in the East North Central region, and has raised new concerns about the viability of heavy industry in the area.

Thus far in the expansion, Michigan has led the way among heartland states, registering an 11-percent increase in employment since the recession low. And the other states of the region generally show a similar pattern, with job growth ranging from 6 percent in Illinois to 9 percent in Indiana. In Wisconsin, where the recession was relatively mild, the state's 3.4-percent increase in jobs has been enough to reduce unemployment to 7.6 percent—the lowest rate in the Industrial Heartland.

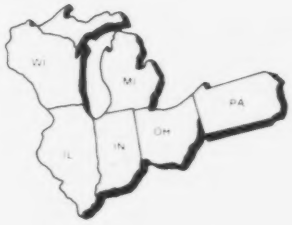
Although the recovery in the East North Central sector has paralleled the expansion of economic activity in the United States, the recession was far more severe at the regional level. As a result, the area remains well below its 1979 employment high, despite seven quarters of sustained upturn. In fact, September's statistics show that the East North Central is the only major region of the United States which has failed to regain the prerecession peak job level.

Table 2: Unemployment Rates—October 1984—"Industrial Heartland"

Michigan	10.9%
Ohio	9.5
Illinois	9.4
Pennsylvania	9.0
Indiana	7.8*
Wisconsin	7.6*

*September

INDUSTRIAL HEARTLAND



At latest count, the number of jobs in the Industrial Heartland stood nearly 500,000 below 1979, underscoring the importance of sustained expansion in the national economy in 1985 if the region is to make further progress toward regaining economic health. However, most recent statistical reports confirm that, for now at least, the U.S. economic expansion has stalled. The recent weakness reflects overbuilding of inventories and further inroads by imports into domestic markets. New orders for durable goods have dropped sharply since April, signaling a period of sluggish manufacturing activity, especially in the key basic industries that drive the economy of these heavily industrialized states.

Notwithstanding the recent loss of forward momentum, the odds now favor reacceleration of economic growth during the months ahead. The period of inventory correction appears to be nearly over, and the significant easing of monetary policy and interest rates in recent months should shortly be reflected in a pickup in the rate of economic activity. On the other hand, the overvalued U.S. dollar has yet to show signs of sustained decline, suggesting that imports of merchandise will continue to soar and that prospects will remain bleak for U.S. producers attempting to compete in foreign markets.

Illustrating this point, production of capital goods has long been a mainstay of the Industrial Heartland region.

Table 3: Recovery in Spending on Capital Goods, Domestic and Imported—Percent Change from Q3-1981 to Q3-1984, in Constant Dollars—"Industrial Heartland"

Total capital spending	24%
Domestic production	2
Imports	87

Table 4: Recovery of Employment in the Nation's Regions*—Change in Employment from Pre-recession Peak to September 1984, in thousands—"Industrial Heartland"

South Atlantic	1,127
West South Central	881
Pacific	754
Mountain	492
New England	329
Middle Atlantic*	146
West North Central	64
East South Central	30
East North Central*	-489

*Regions are as defined by the Census Bureau, except that Pennsylvania is counted in the East North Central rather than Middle Atlantic region. The East North Central states plus Pennsylvania comprise the "Industrial Heartland."

Moreover, until recently the United States has enjoyed a substantial surplus on the balance of trade in the capital goods area. However, the strong dollar has increasingly allowed foreign producers to gain control of U.S. capital goods markets, with the import share rising from 14 percent in the third quarter of 1980 to 26 percent in the third quarter of 1984.

Looked at another way, although the recovery has lifted demand for producers' durable equipment at a rate roughly double the usual pace of post-World War II upturns, U.S. production of business equipment has barely returned to its 1981 high. Meanwhile, the expansion of investment spending in the United States has resulted in a near-doubling of equipment imports during the last seven quarters. And it should be noted that much of the strength in domestic equipment output has been concentrated in the high-tech area which provides relatively little benefit to the Industrial Heartland, while the most serious inroads made by imports have been in the basic capital goods markets that are so important to the region's economic health. In sum, the recovery remains incomplete in the Industrial Heartland. And the prospects for continued improvement in the region's key durable goods industries are clouded by the major problems facing the economy, including the $200-billion federal deficit and the stubborn strength of the U.S. dollar.

The Mid-Atlantic

Thomas J. Spitznas
Chemical Bank

Economic activity in the Mid-Atlantic region, which had been quite strong during the Spring of 1984, cooled off during the Summer and early Fall. The recent slowdown in economic growth in both New York and New Jersey is in line with the slowdown in national growth; there are no signs that a recession in the region is imminent.

Growth in nonagricultural private payroll employment in the Mid-Atlantic region trails national growth by around two percentage points, which is typical for this more mature stage of the business cycle.[1] However, because of relatively slower growth in the New York and New Jersey labor force, the region's unemployment rate is still below the national rate.

The New Jersey economy has been especially strong throughout the current national business-cycle expansion. At 6 percent in October, the New Jersey unemployment rate is well below the 7.4 percent national average. While job growth in New Jersey did not quite match the national pace

[1]Expected upward revisions in New York and New Jersey employment data for 1984 will narrow the growth gap somewhat.

MID-ATLANTIC

during 1984, the fact that it came close is surprising, given that the impact of the 1981-1982 recession on New Jersey's economy was mild compared with the impact on the rest of the country. Over the past five years, the New Jersey economy has outperformed the national economy. Since the business-cycle peak in January, 1980, New Jersey private payroll employment has grown around 2½ percentage points faster than national employment.

Retail and wholesale trade have emerged as New Jersey's major growth sectors, while the early pace-setters, finance and services, are now growing at more subdued rates. Growth throughout New Jersey is still somewhat uneven with the Atlantic City area outstripping most other areas by a wide margin, while the Jersey City area continues to lag well behind the rest of the state. A pleasant surprise is the Newark area where employment is growing close to the statewide average.

New York State's economic performance has not been as strong as New Jersey's; however, certain areas within

Table 5: Percent Change in Private Payroll Employment—United States and Mid-Atlantic

	1983	1984 (Estimate)	1985 (Forecast)
United States	0.8%	5.3%	3.3%
Mid-Atlantic	1.0	3.2	2.4
New York	0.5	2.7*	2.2
New Jersey	2.2	4.2*	3.0

*Expected to be revised up

the state did extremely well during 1984. New York City, for example, will record the fastest annual growth in private payroll employment since records began to be kept in the early 1950's. Among the New York City suburbs, Long Island (Nassau and Suffolk counties) experienced strong, well-balanced economic growth for the second straight year. Certain of the upstate New York regional economies are also experiencing solid growth. However, given the relative importance of capital goods production in upstate New York, the performance there has been disappointing. In the midst of a national boom in spending by business on capital equipment, it is puzzling that employment in this sector is virtually unchanged in upstate New York and growing only moderately in New Jersey, while national employment in capital goods industries is up over 9 percent for the year. The failure, at least so far, of New York and New Jersey to participate fully in the capital spending boom could be a reflection of a growing inability of the region to compete with imports of foreign capital equipment.

With the national expansion likely to continue through 1985 at a rate close to the 3 percent historical growth trend of real output, the Mid-Atlantic region should experience another year of solid growth in employment. Compared with 1984, average annual employment growth during 1985 will slow in both New Jersey and New York in response to the national slowdown already under way. However, due to the relatively low share of cyclical industries in the New York and New Jersey economies, the expected slowdown will be less pronounced in the Mid-Atlantic region than nationally.

The Upper Southeast

Kemper W. Baker, Jr.*
Federal Reserve Bank of Richmond

The economy of the Upper Southeast has seen a variety of forces at work in 1984. The result has been significant and durable economic improvement, but not without continued change and a few disappointments. As the business investment sector assumed the leadership of the national recovery, the region experienced major gains in related areas, but drew little support from its sizable consumer goods base. Moreover, the heavy drain of the U.S. merchandise trade deficit intensified. Leadership of the regional economic expansion passed to industries and sectors that had little clout in the region only a few years ago. All in all, the region's new directions and strengths have become more apparent, but the forces of transition have dominated over those of growth, and short-term gains in employment and income have suffered.

As 1984 got under way, expansion in the region was being driven by industries related to housing and automobiles—such as the production of textiles, building materials and supplies, and appliances. As the recovery evolved, its direct and indirect effects reached more sectors and areas of the economy.

*The views expressed are the author's and do not necessarily reflect those of the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of Richmond.

UPPER SOUTHEAST

In terms of the broad measures of economic activity, the Upper Southeast has not kept pace with the nation. Personal income growth has been only slightly below the national average, but employment growth had fallen well short as of mid-year. Within the region, only South Carolina added jobs faster than the national average. Kentucky, North Carolina, and South Carolina each out-performed the nation in personal income growth, and Delaware could be added to the list if nonfarm income were the measure. The outlook for the region, however, is better than recent performance might suggest.

Employment gains were achieved virtually without help from most of the region's major industries—furniture and fixtures, textile mill products, apparel, lumber and wood products, chemicals and tobacco products. In fact, these six industry groups combined for a net loss of almost 1,500 jobs in the region from July, 1983 through July, 1984. Chemicals, textiles and tobacco actually suffered employment losses over the year. Of the other traditionally important industries in the region, only coal is showing truly outstanding gains in output and employment this year. On

the other hand, the machinery and electrical equipment manufacturing groups gained nearly 33,000 jobs region-wide, reaching a total of more than 350,000 by mid-year. Even the primary and fabricated metals sectors added over 6,000 jobs, and rubber and plastic products did nearly as well. These showings have structural and long-term, not just cyclical, underpinnings.

The restructuring of the regional economy has rightly been the topic of much discussion and analysis. The issue at this point, however, is how the region will fare in a period of slowing national economic growth. Where can the region look for employment and income gains in 1985? In the short run, the potential of the region continues to depend on the growth of world output and trade, and on the course of U.S. net exports.

There is still substantial cause for optimism concerning the near-term performance of regional industries and businesses. The relatively slow growth in income and employment is somewhat misleading, since major sectors of the economy are in transition. The textile industry, for instance, has invested heavily in new equipment of late. As a result, output and profitability measures tell a different story from the employment tale. Imports are a concern, to be sure; the 1984 trade deficit for textiles and apparel is likely to exceed last year's $10.6 billion record by 50 percent or more. However, it seems likely that the shakeout in the textile industry has largely run its course. The industry should maintain, or even augment, last year's gains in output and profitability, and employment should tend toward stability.

The process is somewhat less advanced among apparel and furniture manufacturers, although furniture also looks better from an output than from an employment perspective. Other prominent regional industries where year-to-year gains seem to be running ahead of economywide averages are tobacco products, paper, chemicals and household durables. These gains should hold through 1985, and might even grow if some help from export markets were to materialize.

The transportation and distribution sectors, particularly those associated with the region's several major ports, are emerging from a very good year with every expectation of further advances, especially if a pickup in exports materializes. A contributing factor, of course, has been the major expansion of U.S. coal production, much of which has occurred in the region. Coal exports have disappointed some industry observers in 1984 because, while gains have been significant, they have been almost entirely in the metallurgical segment; exports of steam coal have shown little growth. Nonetheless, a coal-production record looks well within reach in 1984, and the near-term prospects remain positive.

In sum, the regional economy could finally shake free of the drag that has been imposed by its older industrial base. Without this constraint, the region will be positioned to make real economic gains on the strength of its newer and more rapidly growing sectors. Exceptions to the pattern of the traditional industries will continue to be found in the machinery and electrical equipment groups, and more generally in the technically oriented manufacturing and service industries where recent gains reflect more than cyclical improvements in employment and output. Several significant pockets of these technically oriented industries have become well established in the region and now give impetus to the growth of new and established businesses, in addition to their government and research activities.

The Upper Southeast has discovered the severe regional effects of a national economic slowdown or downturn. Clearly, regional prosperity requires growth of the national economy. In addition, the results of 1984 suggest that international growth may also be essential. Although the outlook for the world economy is far from clear, under the assumptions of moderate U.S. growth and a modest improvement in growth for the rest of the world, 1985 looks quite good for the Upper Southeast. With any help at all from its large traditional industrial base, the region could begin to recoup the share of national employment and income it appears to have lost in 1984.

The Lower Southeast

John M. Godfrey
Barnett Banks of Florida, Inc.

LOWER SOUTHEAST

The five states comprising the Lower Southeast region were driving forces behind the surge of economic activity across the nation in the first half of 1984. However, the strong growth that characterizes the cyclical rebound phase of the expansion has passed, and future gains will likely be at a slower pace, but one more sustainable in the long run. The inherent attractiveness of the Lower Southeast region will result in its continuing to show gains in population, income and jobs that are above the national averages. However, sharp differences are still apparent in the economic health of these states, suggesting that major structural changes will be required before the economic performance of all states in the region equals the national pace.

Income growth at over 10 percent has been the norm for

this region in 1984, and provides solid evidence of the area's fundamental strength. This is a marked acceleration from the prior year. By this measure, Georgia, Tennessee and Alabama are leading the region but some of the strength is more apparent than real. Alabama, Mississippi and, to a lesser extent, Tennessee were unusually hard hit by the recession so that previous income peaks have not yet been exceeded. The strong rebound in these states merely reflects that extreme cyclical underpinning of the industrial base. Florida, the state experiencing the least impact from the national recession, and for nearly two and one-half years a major force lifting the nation out of the recession, continues to post solid income growth.

The states with the strongest employment gains are Florida, Georgia and Tennessee. Florida and Georgia labor markets also exhibit unemployment rates more than 1 percentage point under the national level. In contrast, lingering problems exist in Tennessee, with the unemployment rate a percentage point above the national average. These three states have not only exhibited large gains in the cyclical sectors of construction and manufacturing but also in sectors associated with long-run fundamentals—trade and financial, business and personal services. Job growth across the board reflects the attractiveness of these states.

However, nearly two years of expansion have not lifted Alabama and Mississippi over past peak levels of activity. Unemployment is down but remains above 10 percent at a time when the nation as a whole has recovered. With employment heavily concentrated in the slow-growing parts of the manufacturing sector, recovery in these states has been limited. Unless the manufacturing outlook brightens, activity in other sectors will continue below par. Construction, trade and services alone cannot make up for the lack of a full recovery in the manufacturing sector.

"America's Breadbasket"

Marvin Duncan*
Federal Reserve Bank of Kansas City

The nation's farmers can look forward to marked improvement in net farm income in 1984. The forecast $31 billion is nearly double the $16.1 billion earned in 1983. Cash receipts from both crops and livestock sales are up modestly from 1983. Direct government payments to farmers will be large—perhaps only $1.5 billion below the $9.3 billion they received in 1983.

The higher farm income in 1984 is due to a number of factors. Much larger planted acreage has yielded very large—but not record—production for major crops. Corn production was 7.55 billion bushels, soybeans 2.03 billion bushels, wheat 2.57 billion bushels, and cotton 13.3 million bales. During the early part of the previous crop-marketing year, prices received by farmers for crops exceeded those of a year earlier. The value of farm exports in 1984 reached $38 billion, up more than $3 billion from the year earlier. A substantial portion of government Payment-In-Kind payments to farmers, though earned in 1983, was received in 1984. The increase in the index of prices paid by farmers for production items was small: In October, it was only 0.25 percent above the year-earlier level. Finally, and very importantly, larger farmer-held inventories of crops and livestock are expected to add about $9 billion to net farm income; inventory reductions of $11.7 billion sharply reduced total net income in 1983.

The difference between cash income and cash expenditures—net cash farm income—is forecast to decline about 10 percent from the record high $40.1 billion earned in 1983. On the other hand, off-farm income earned by the farm sector is forecast to reach $43 billion, up 5 percent from 1983.

AMERICA'S BREADBASKET

Despite the best farm-income year since 1981, the farm sector is troubled by financial stress. Not since before World War II have farm financial problems been so pervasive. In the Tenth Federal Reserve District, farm-business liquidations due to financial stress during the second and third quarters of 1984 were 2.8 times what agricultural bankers would consider normal, and partial liquidations were 3.0 times normal. Even greater proportions of full and partial liquidations are in prospect for the Winter of 1984-1985, as farmers settle 1984 lines of credit and arrange credit for the 1985 crop year. While farm financial stress appears concentrated in the western, midwestern and central Great Plains, the problem is really national in character. During 1984, farm asset values have declined significantly in the Southwest. But for massive infusions of subsidized credit by the Farmers Home Administration during the late 1970's, conditions in the Southeast would be far worse than now apparent.

*The views expressed are, unless otherwise indicated, those of the author; none is intended, nor should be construed, as representing the Federal Reserve Bank of Kansas City or of the Federal Reserve System.

Table 6: Net Farm Income—billions of dollars—"America's Breadbasket"

	1980	1981	1982	1983	Forecast 1984
Net cash income	37.7	35.0	36.8	40.1	36
Net farm income	21.2	31.0	22.3	16.1	32
Real net farm income (1972 dollars)	11.9	15.9	10.8	7.5	14

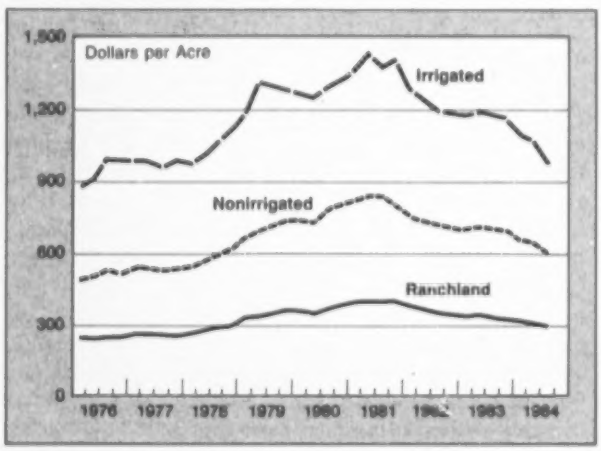
Farm financial stress has resulted from a sharp increase in the real (inflation adjusted) interest rates paid on farm debt, as well as from low commodity prices. Those farmers owning outright less than half of their farm assets have frequently found debt-servicing costs so high that their operating returns have been negative. Compounding the problem, high real interest rates and low commodity prices have caused farm asset values to decline substantially in many parts of the nation. In the Tenth Federal Reserve District, farm land values in the Fall of 1984 were about 30 percent lower than the market high reached in 1981. Moreover, further declines in land values appear likely in the year ahead.

Farm income in 1985 is unlikely to be higher than in 1984 and could be somewhat lower. Debt-carrying costs seem likely to remain quite high and the index of prices paid by farmers for production items could rise more quickly in the year ahead. Crop producers face the prospect that large planted acreage will result in another large crop in 1985, adding to carryover stocks. Thus, crop prices may average somewhat less in the year ahead. Livestock producers, however, appear poised for a profitable year in 1985. Reduced cattle and hog numbers mean lower red-meat production capacity will restrain production of pork and beef. Continued growth in employment and personal income should then result in stronger livestock prices for farmers. Higher poultry output will partially offset red-meat reductions, however.

Uncertain income prospects and high levels of financial stress mean farmers will not be good customers for capital goods. Farm-equipment manufacturers are probably in for another year of disappointing sales. Postponement of a broad range of discretionary purchases by farmers means that rural communities will also experience somewhat higher levels of financial stress in 1985.

Although the farm sector continues to experience substantial amounts of financial stress, events are setting the stage for a more lasting recovery in farm profitability within a couple of years. Farm-asset values should stabilize within a year or two at levels providing positive returns to investors. Continued economic recovery should spur export demand. Action to reduce federal budget deficits would result in both lower real interest rates and a lower value for the U.S. dollar in foreign-exchange markets. That combination of events would reduce farmers' debt-carrying costs and improve their competitive position in export markets. The stage could then be set for some modest appreciation in farm-asset values.

Farm Real Estate Values



The Southwest

William C. Gruben*
Federal Reserve Bank of Dallas

The recent economic experience of the four states defined here as the Southwest is greatly varied. Overall, the region is recovering from the economic recession of 1981-1982, but at a slower rate than the nation. During the second half of 1984, growth in the Southwest has decelerated, as it has nationally; but the gap between the U.S. rate of growth and that of the Southwest has lately widened somewhat.

SOUTHWEST

*The views expressed are, unless otherwise indicated, those of the author; none is intended, nor should be construed, as representing the Federal Reserve Bank of Dallas or of the Federal Reserve System.

Table 7: Recent Percent Changes in Nonfarm Employment—United States and Southwest
(Seasonally Adjusted at Annual Rates)

	Q2-1984 to Q3-1984	State and Regional Change as Percent of National Change	Q3-1983 to Q3-1984	State and Regional Change as Percent of National Change
United States	3.2	—	4.6	—
Southwest	1.6	50	2.4	53
Arkansas	3.3	101	4.0	87
Louisiana	1.4	44	0.8	17
Oklahoma	1.3	40	1.9	42
Texas	1.5	46	2.9	63

Over the last year, the recovery in each of the four states of the Southwest has been slower than that of the nation. Recent year-over-year growth rates of nonagricultural employment in Arkansas, Louisiana, Oklahoma and Texas vary considerably, but all fall markedly below the nation's. For the three months ending in August, the U.S. industrial production index was up 10.8 percent from the same period a year earlier, compared to only a 9.3-percent increase in the Texas index.

The rate of recovery in the Southwest has generally been declining. In the third quarter of 1984, Texas' rate of nonagricultural employment growth was 75 percent as fast as in the second quarter, 37 percent as fast as in the first quarter, and 33 percent as fast as that of the fourth quarter of 1983. Although the patterns of change in the other southwestern states differ somewhat from that of Texas, a tendency toward weakening growth is also clear in Oklahoma and Arkansas. Louisiana's growth has accelerated, but the state remains among the poorer performers in the Southwest by almost any measure.

Since Texas' income, employment and population are greater than those of the other three southwestern states combined, movements in Texas variables can mask opposing movements in the variables for the other states. Thus, while it is true that the gap between the U.S. recovery and that of the Southwest has widened, this reflects an actual widening only in Oklahoma and Texas. In Texas, the gap is widening by almost any measure. For the three months ending in August, growth in the Texas Industrial Production Index from the year-earlier period was 86 percent as fast as the growth of the U.S. index; and compared to the immediately previous three-month period, the Texas index grew only 23 percent as fast as the nation's. Growth in Texas' nonagricultural employment has also slowed relative to the nation's. While the differential between the rate of nonagricultural employment growth in the nation and in Louisiana and Arkansas has narrowed, only Arkansas has lately enjoyed growth rates that match the nation's.

The overall recovery in the Southwest has been relatively weak because the area's most important industry, energy, has performed sluggishly. Drilling has not approached the rates it achieved in 1981, although it has lately been showing year-over-year increases in Oklahoma, Louisiana and Arkansas. In Texas, drilling rates have remained below year-earlier levels. This difference in drilling experience partially explains why Texas' recovery gap vis-a-vis the nation has widened, while those of Louisiana and Arkansas have narrowed.

Other energy-related elements of the southwestern economy have also slowed the region's recovery. Refining output, for example, has been low and significant layoffs have occurred in Texas and Louisiana. It should be noted that Arkansas, the southwestern state least influenced by oil and gas extraction and refining, also has shown the strongest recovery of the four states. Until very recently, however, even Arkansas' recovery has been slower than the national pace.

Another reason why the gap between Texas' growth and the nation's has widened, while the gaps have narrowed in two other southwestern states, is seen in the patterns of construction activity. In Texas, as in other portions of the Southwest, growth in construction spending helped to fuel the early stages of the recovery. But construction spending in Texas has weakened considerably since then. Compared to a year earlier, nonresidential building expenditures in 1984 (through September) were up 17 percent for the nation, up 4 percent in Louisiana, up 18 percent in Oklahoma, and up 42 percent in Arkansas, but down 7 percent in Texas. On a similar basis, residential building expenditures were up 12 percent nationally, up 49 percent in Arkansas, up 5 percent in Louisiana, but down in Texas and Oklahoma.

Growth rates have also varied considerably among areas within the region's states. The Oklahoma City area, for example, is growing slowly, but is enjoying considerably more economic health than Tulsa. In Texas, areas dependent on energy, such as Beaumont-Port Arthur-Orange and Houston, are weaker by almost any measure than Dallas-Ft. Worth, San Antonio, or Austin, where energy is not very important but electronics and defense contracting are. Cities along the Mexican border have not fully recovered

from the effects of the 1982 peso devaluations. Nevertheless, employment is growing along the border and unemployment rates there have generally been falling.

An outlook for continued sluggishness in most industries tied to energy suggests ongoing weakness in the recovery of the Southwest during 1985. Ebbing nonresidential and residential construction activity will also slow growth in income and employment in the region as a whole. Even so, the Southwest is likely to sustain its pattern of upward movement, and the electronics and defense-related urban areas will remain the most economically healthy population centers in the region.

The Mountains

Tucker Hart Adams
United Banks of Colorado

As 1984 comes to an end, the Mountain region is rebounding vigorously after enduring the worst downturn in almost 20 years. Although the region lagged the national recession by half a year, its recovery was also one-half year later than the national upturn. The strength of this recovery is borne out by the statistics. After rising a scant 0.1 percent in 1982 and 0.9 percent in 1983, nonfarm employment in the region gained a strong 4.0 percent through August, 1984, approximately three-fourths the average annual growth rate of 5.4 percent during the 1970's. Help-wanted advertising is more than double its recession low. Unemployment averaged 8.6 percent in 1983, one full percentage point below the national average; but by August, 1984, the regional unemployment rate had fallen to a low 5.6 percent, over five percentage points below its peak. Arizona and Colorado recorded the lowest unemployment rates in the region at 4.5 percent and 4.7 percent, respectively. Population growth, a meager 1.7 percent in 1983 and estimated to be 2.5 percent in 1984, remains below trend.

In 1983, regional income grew 6.4 percent, which approximated national growth. This was only three-fourths the region's trend rate in the 1970's (after inflation adjustment), and was more a reflection of the lagging regional recovery than of underlying poor growth. Indeed, by mid-1984, income in the region was advancing at 9.8 percent. Growth, however, was uneven: While Utah and Arizona payrolls advanced in excess of 11 percent, Montana registered only a 7-percent gain.

The housing industry enjoyed a prosperous year in 1983. Housing permits rose 65 percent as declining mortgage rates unleashed pent-up demand. Despite strong initial gains in 1984, permits rose only 5.5 percent through the first three quarters. The housing recovery will be quelled by rising mortgage rates; moreover, much of the 1983 gain reflected apartment building in Arizona and Colorado, and the oversupply in this sector will cause residential construction to decrease.

Despite office vacancy rates that are stuck at almost 30 percent in Denver and Phoenix, nonresidential construction has held its own, gaining 4.8 percent in 1983 and 11.9 percent in the first three quarters of 1984. Significant nonresidential construction in Arizona offset declines in other states.

Despite higher inflation, higher interest rates, and a stagnant energy industry, the recovery in the Mountain states

Table 8: Mountain Region Economic Indicators

		Estimate	Forecast	Percent Change	
	1983	1984	1985	1984	1985
Personal income (billion $)	134.0	147.0	160.2	9.7	9.0
Retail trade (billion $)	64.0	69.9	76.2	9.2	9.0
Employment (thousands)	4,626	4,807	4,961	3.9	3.2
Unemployment (percent)	8.6	6.2	6.0	N/A	N/A
Housing construction (thousand units)	165.1	171.0	140.2	3.6	(9.9)
Nonresidential building (billion $)	4.6	5.1	5.4	10.7	6.5
Population (thousands)	12,331	12,639	12,981	2.5	2.7

will continue through 1985. Slower, yet more sustainable, growth will be evident. Population will increase 2.7 percent; although this is less than the 3.2 percent trend of the 1970's, it is in line with what is expected for the 1980's and is robust in comparison to the rest of the nation. Much of the Mountain region's population growth during the 1970's was due to net migration. As the "baby boom" generation ages out of the highly mobile years (20-29), migration to the Mountain region will slow, and bring about slower population growth.

Job growth will continue to be strong in 1985. The gain will be 3.2 percent, or 154,000 jobs, but they will not be evenly distributed across the economy. Manufacturing and services will post strong growth, but the mining industry will falter. Overall, the employment rate will fall to 6.0 percent (after dropping 2.4 percentage points in 1984), as labor-force growth picks up in response to improved job opportunities.

As employment and population increase in 1985, personal income will surge 9.0 percent. Combined with an inflation rate which may reach 6.5 percent by year-end, this translates into a good gain in real purchasing power. Retail trade will also increase a healthy 9.0 percent. This growth is slightly below 1984's pace, however, and is indicative of the region's lagging recovery that caused robust growth to peak in 1984 rather than in 1983, as was the case with the nation. Moreover, growth in consumption spending will slow in 1985 as business investment continues to sustain economic activity.

Construction will weaken. Housing starts will drop nearly 10 percent in 1985 because of higher interest rates and an overbuilt multifamily sector. Nevertheless, at 140,200 units, the level of housing construction will remain above its average of the 1970's. The rise in nonresidential construction outlays will slow from the 1984 pace, and will only slightly outrun inflation. An overbuilt office market will cause that sector to suffer, but factory, retail, utility and infrastructure building will compensate for the decline.

The Pacific

Joseph A. Wahed
Wells Fargo Bank, N.A.

The economy of the Pacific region performed pretty much as expected during 1984.[1] All in all, the region's pattern was surprisingly similar to that elsewhere in the nation and any difference was one of degree rather than direction. The first half of the year was particularly vigorous but activity slackened noticeably during the Summer and early Fall. Probably the most surprising events of the year were the decline in interest rates after mid-year and the lack of inflationary pressures.

Those industries that were supposed to do well did so, while those that were perceived as still struggling early in 1984 continued in this vein during all of 1984. In brief, no major surprises. But overall, business activity for the Pacific states improved greatly. Employment rose substantially, particularly in California, and unemployment fell; sales rose in most industries, resulting in significant gains in profit margins; confidence levels improved, especially in the forest product industries of the Northwest, even though they had not fully recovered from recession. In the important tourist industry, the year 1984 was somewhat spotty. The Olympic games in Los Angeles were disappointing in their economic impact and tourist activity in general was somewhat below expectations in Southern California.

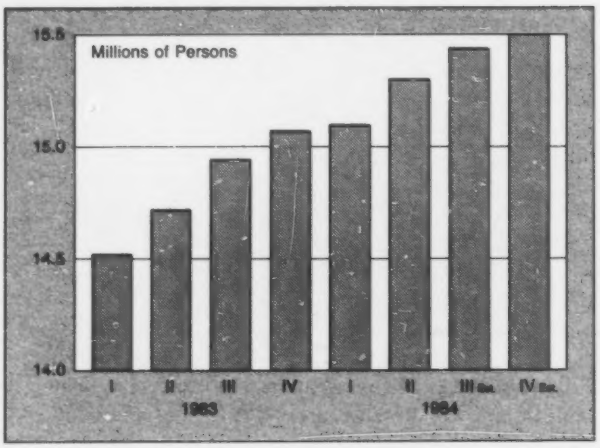
However, it was a different story in Hawaii, where tourist activity rose an estimated 10 percent in 1984 and hotel occupancy rates reached a comfortable 70 percent.

Perhaps the strongest gains took place in the region's critical defense-electronic-aerospace sector. Sharply higher demand for electronic equipment and even stronger growth in military markets spurred business activity in Southern California, the San Francisco Bay Area, Seattle and Hawaii. Construction activity was also very strong, especially in the industrial and commercial sectors. Housing construction rose in the first half of the year but fell quickly during the second half because of higher mortgage rates.

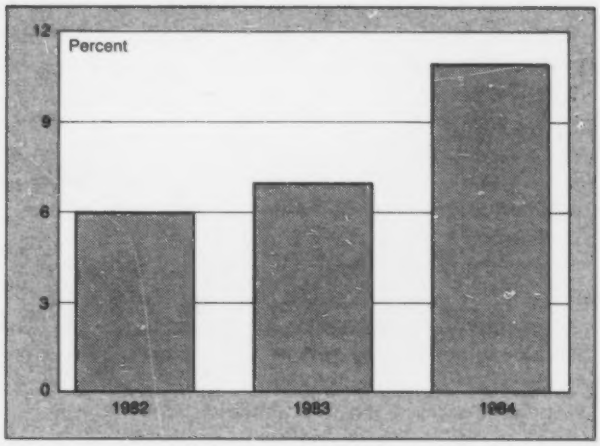
Not all industries were fortunate enough to experience

[1]The Pacific region includes California, Oregon, Washington, Alaska and Hawaii and accounts for roughly 15 percent of the U.S. economy. Its population is 34 million, of whom 15.4 million are employed. Total personal income is estimated at $476 billion; per capita income is $14,000.

Employment in the Pacific Region



Growth of Pacific Region Personal Income



growth and prosperity. Agribusiness continued to be caught in a classic cost-price squeeze and many farmers—in California and elsewhere—faced bankruptcy. In addition, a variety of export industries—including agriculture—were hit hard by foreign competition and an overvalued U.S. dollar, as well as by sluggish demand abroad. The airframe industry in Southern California and Seattle continued to feel the competition from the French-British Airbus. And, in the Pacific Northwest, the lumber industry went through a veritable seesaw as cheaper Canadian lumber entered U.S. markets and as U.S. housing activity eased after the summer months.

There was a clear disparity in growth rates among the states of the Pacific region. In Hawaii, the economy improved only moderately, despite the recovery in tourism and defense. In Alaska, weak energy prices hurt production and exploration. In Washington and Oregon, economic growth rose but it was pock-marked and erratic because of the ups and downs in housing and lumber. In California, business activity exceeded even the most optimistic expectations despite the problems facing agribusiness. The state had one of the most robust years in its history.

In the months ahead, the Pacific region is expected to continue to grow. The easing in interest rates and the growth momentum created since 1983 will be the key forces of expansion. Growth will not be as explosive as in early 1984, but it will be sustained and fairly steady. Housing should improve as mortgage-interest rates fall further while export markets *may* pick up a little as the U.S. dollar loses ground.

All in all, continued growth into 1985.